IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-1088

CHESTNUTT CORPORATION,

Petitioner,

—v.—

MILDRED GALFAND,

—and—

AMERICAN INVESTORS FUND, INC.,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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CHESTNUTT CORPORATION (a Connecticut corporation) seeks a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Second Circuit entered October 25, 1977.

Opinions Below

The judgment is not reported (72a).* It affirmed a superseding judgment of the Southern District of New York (Brieant, J.) awarding $145,072 following remand by the Court of Appeals. (545 F.2d 807) (52a). A decision of the

* "a" refers to appendix hereto.
"A" refers to appendix below.

District Court in Philadelphia denying an injunction is reported at 363 F.Supp. 291 (5a) and Judge Brieant's original decision was reported at 402 F.Supp. 1318 (21a). Judge Brieant's decision on remand is unreported (67a).

Jurisdiction

This Court's jurisdiction is invoked pursuant to 28 U.S.C. §1254(1). The entry of the Court of Appeals' judgment was October 25, 1977. Time was extended to February 2, 1978.

Questions Presented

Where there is no challenge to a penny of mandatory expenditures of a no-load mutual fund or to the unchanged rate or amount of any advisory fee, and a proposed advisory agreement was *prospective* only—

1. Whether §36(b) of the Investment Company Act of 1940 which created a "fiduciary duty with respect to the *receipt* of compensation for services or of payments of a material nature" can possibly be applied to mandatory disbursements to third parties (principally postage, printing and bank charges) to hold an investment adviser liable to pay a windfall subsidy to the Fund, in effect changing the statute to a penalty clause. (Emphasis added)

2. Where it is admitted that all statements of existing fact in a proxy statement were true, whether injection at the instance of the SEC* of one true fact rendered the proxy statement misleading and whether it was also misleading in failing to violate the SEC's first example of a misleading statement "(a) Predictions as to specific future

* "... loose language on the part of a government employee ..." (39a)

market values or dividends." (Reg. §240.14a-9, 17 CFR §240.14a-9), which "predictions" are a necessary predicate to the decisions below, and whether plaintiff had standing.

3. Whether requiring predictions of stock prices has also substituted a subjective test of motive for the objective test of materiality commanded by *TSC Industries* v. *Northway*, 426 U.S. 438 (1976)—" . . . would have actual significance in the deliberation of the reasonable shareholder." (*id.* at 449)

4. Where the Adviser under §10(d) of the Act was specifically authorized to charge a no-load Fund at 1% advisory fee, but charged a 0.57% fee in 1973 and a 0.61% fee in 1974, whether any other standard is applicable.*

5. Whether any injury was caused by the Adviser.

6. Whether the decisions below in whole and their various parts are federal corporation common law overruling statutes.

Statutes Involved

Printed in the appendix are the following sections of the Investment Company Act of 1940 (15 U.S.C. §§80a-et seq.): §10(d), §15(c) and §36(b). We refer to a portion of an accounting Regulation of the SEC (Reg. §270.2a-4b, 17

* About four months after the first of four annual stockholder approvals by 80%, the oil embargo threw the stock market out of bed in November 1973, thereby increasing the relative importance of housekeeping disbursements, which for shares entitled to vote resulted in 1973 liability on a daily basis of 2/100,000ths. of a penny per share and of 37/10,000ths. of a penny per share on 244 days of 1974, aggregating less than a penny a share over the 609 day liability period. The Adviser did not predict the oil embargo, *vel non*.

C.F.R. §270.2a-4b), which provides that expenses of an investment company:

> "... need not be so reflected if cumulatively, when netted, they do not amount to as much as 1 cent per outstanding share."

The proxy Regulation (applicable by reason of §20 of the 1940 Act), including the first example of a misleading statement, provides (17 C.F.R. §240.14a-9, Reg. §240.14a-9):

> "Reg. §240.14a-9. (a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.
>
> "(b) The fact that a proxy statement, form of proxy or other soliciting material has been filed with or examined by the Commission shall not be deemed a finding by the Commission that such material is accurate or complete or not false or misleading, or that the Commission has passed upon the merits of or approved any statement contained therein or any matter to be acted upon by security holders. No representation contrary to the foregoing shall be made.
>
> "Note: The following are some examples of what, depending upon particular facts and circumstances, may be misleading within the meaning of this section.

> "(a) *Predictions* as to specific future *market values* or dividends." (Emphasis added)
>
> * * *

Statement of the Case

A. *Introduction*

Plaintiff sued, sat back, waited and prospered. She was neither a buyer nor a seller and retained the benefit of her shares, reinvested dividends while suing, and neither she nor any other shareholder ever suffered even 1 cent *paper* loss or *actual* loss by reason of the acts complained of. Further, the value per share increased from $4.46 on the date of the proxy statement to over $6 since the superseding final judgment. The terms of the agreement have now been approved at four annual meetings.

B. *Background*

Federal statutes command mutual funds to spend money for rigid corporate housekeeping including bank custodian and transfer agent charges, printing and postage for disclosure and notices to *existing* shareholders, independent accountants, fidelity bonds, etc. Federal statutes do not limit with one hand the amount or proportion of payments which they have required with the other.

There is no challenge to the necessity, or the propriety, or the amount, or the proportion of such mandated expenditures, nor any suggestion of "waste" or sloppy management. Rather, "penalizing" an investment adviser was sought and obtained to produce windfall profits to the mutual fund of a portion of its *own* mandated expenses paid to third parties, purportedly on the basis of federal statutes alone.

There is no challenge to the 0.57% advisory fee for calendar year 1973 or the 0.61% advisory fee for calendar year 1974.

There is no allegation of diversity or state law.

To the extent a mutual fund succeeds in the 1940 Act's purposes of serving a large number of small investors,* to that very extent and by its very success in fullfilling the statutory purposes these housekeeping expenses will increase,** exceeding $6 per shareholder account here.

Notwithstanding the detailed, active and pervasive federal regulation which commands these expensive housekeeping chores (while at the same time not impeding or impairing the performance of these commands by limitations), a few states have by indirection sought to ride herd on interstate commerce by elusive "blue sky" ground rules, or, as in California, by regulation.

To do so, a handful of state regulators seized upon a *disclosure* requirement of the SEC, and turned it into a *banishment tool.* The SEC requires mutual funds to issue a new prospectus each year, copies of which must be sent to *existing* shareholders such as plaintiff as well as new shareholders. This particular *disclosure,* which must be printed no later than page 5, must show for 10 years the aggregate of expenses, *plus* advisory fees, stated as a ratio

* The parties stipulated that at the time of trial the Fund's entire investment performance since 1958 through 1974 was three times as good as the Dow-Jones Industrial Average, up 116% per share, versus only 38.4% on the DJIA. (Pretrial Order, ¶26, A-37) At the end of 1977 (in which year the Fund's shares were plus 3.67% and the DJIA minus 17.2%) the Fund was plus 248.50% contrasted with 86.68%, or 2.9 times as good as the Dow Jones Industrials since 1958.

** Federally mandated Fund disbursements increased by 70% (from $508,340 to $865,010) principally for custodian and transfer agent fees to Bank of New York, postage and printing for shareholder reports, etc. in the 5 year period 1967-1972, even though Fund total net assets decreased 15% in the period. (Ex. B, and as found by the district court in Philadelphia denying an injunction 12a)

to total average net assets. This federal "expense ratio" disclosure was adopted as a benchmark, and California imposed as a condition of state qualification that federal investment advisers agree that in the future the "expense ratio" would not exceed 1% of average net assets, requiring a federally registered adviser to refund any excess to a mutual fund.

California went so far as to outlaw the express permission under federal statute law, which permits a *no-load* fund to have only *one* outside director if, as is the case with this Fund, the advisory fee alone does not exceed 1% and which does not bear sales or promotion expenses or rent or salaries (§ 10d(6) of 1940 Act).

Known to the World, known to the plaintiff herself, and required by the SEC to be printed at the Fund's expense and mailed at the Fund's expense, and known to every shareholder* was the Fund's decade of "expense ratios" prior to the proxy statement complained of on page 5 of the April 1973 prospectus for the Fund's calendar years as follows (Pl. Ex. 1, page 5):

"Ratio of Operating Expenses to Average Net Assets. . .

1963	1964	1965	1966	1967	1968	1969	1970	1971	1972
1.42%	1.23%	1.29%	1.09%	0.88%	0.86%	0.86%	1.02%	0.98%	0.92%"

Thus, when Pennsylvania plaintiff first invested $250 by mail to New York (neither of which states has ever had an expense ratio limitation) in October 1968, there had been only one year, 1967, when the 1% expense ratio had been

* One of many wholly inexplicable statements below:

"Prior to 1973, Chestnutt Corporation's fee was not seriously threatened by the expense ratio limitation" (57a)

demonstrates how completely both courts below misconceived this case.

bettered, and the expense ratio reached 1.02% in 1970, two years before the acts complained of, the same as in 1973, the year complained of.

California saw fit about 1972, possibly in the light of inflation and in the interest of encouraging sales to small shareholders, to increase the allowable expense ratio from 1% to 1½% on the first $30 million, or an increase of $150 thousand—from $300 thousand to $450 thousand per year.*

When plaintiff first invested $250 in October 1968, as the trial court found:

> "The Fund and its Adviser had an established custom and practice of executing two year agreements which were replaced annually, a year prior to the expiration date." (23a)

Thus, in accordance with the actual practice since 1958 of adopting a new contract every year there was presented to shareholders of the Fund a proposal to conform the advisory agreement for future services to California limitations.

This proposal submitted to 110,000 shareholders led one shareholder to bring this action.

She has retained the benefit of her shares which were worth $4.46 on the date of the proxy statement as well as accepted the benefit of the future investment advisory services so that after the superseding final judgment the value exceeded $6.00 per share. At no time has plaintiff or any other shareholder suffered even a penny loss, either on paper or upon redemption, on any day nor upon the aggre-

* By the time of trial California had changed to an expense ratio limitation of 2% on the first $10 million, 1½% on the next $20 million and 1% on the excess.

gate of the 609 day liability period by reason of the acts complained of. Likewise, future investment advisory services have benefitted the fund itself, through the four stockholder approvals, by tens of millions of dollars.

C. *Proceedings Below*

The original complaint was dismissed as moot July 26, 1974. Mrs. Galfand filed suit Friday, July 6, 1973 to enjoin a no-load mutual fund's annual meeting of shareholders noticed for Tuesday, July 17, 1973. She failed, and more than 80% of the shareholders approved a new advisory agreement.

More than a year later on August 14, 1974, and following a second shareholder annual approval noticed for July 18, 1974 of the same terms, which she admits to be valid, she filed with permission an amended complaint for money damage attacking the first annual approval in 1973, but not the second annual approval in 1974 of the same terms. Nor has she attacked two subsequent approvals of the same terms in annual meetings.

Neither New York (the Fund's State of incorporation), nor Pennsylvania from where plaintiff purchased shares by mail, nor federal law has ever directly or indirectly sought to limit the amount or proportion of mutual fund's housekeeping expenses, which exceeds $6 per shareholder account.

Plaintiff sought damages solely under §36(b) relating to "fiduciary duty". That is the only section under which damages were awarded—penalizing the adviser for a portion of the Fund's housekeeping expenses, even though not a single cent of disbursements was challenged and there was no attack on the rate or amount of the decreasing scale of the advisory fee.

The trial court used a legal standard ("might") expressly rejected by this Court, in *TSC Industries, supra.* The Court of Appeals said the correct standard showed the proxy statement was misleading on its face, although it did not repeat the trial court's "loose language on the part of a government employee" (39a) as injecting a misleading statement by the SEC itself.

Neither court gave any consideration to the fact that any estimate of a future "expense ratio" necessarily involved "predictions as to specific future market values" of the Fund's portfolio in express violation of the proxy rule itself, but the courts said it was necessary anyhow. Nor did either court note that the *actual* market value was in fact disclosed.

It is undisputed that each director of this no-load fund each week received *all the information known to the Adviser,* which consisted of a Fund balance sheet itemizing each security, each transaction, net asset value per share and total net assets (A 163-164). The panel ignored this, as well as the fact that the Adviser *lost* \$248,000 in 1973 alone, and lost an additional \$180,000 to \$200,000 in 1974 (estimated early in 1975 at the time of trial) (A 166-167).

On page 5 the proxy statement set forth the existing schedule of rates for the fee and the actual net assets of \$150,102,469,* and in the same paragraph on the next page gave the actual advisory fees for three years "1970—\$1,175,215; 1971—\$1,243,301; and 1972—\$1,165,812."

Immediately following was a proposal to increase the allowable "expense ratio" to 1½% from 1% of average net assets.

* Net assets jumped to \$174 million by the end of October, 1973 and the former 1% limit would not have been exceeded but for the Arab Oil Embargo.

The final sentence on that page 6 reads:

> "However, no assurance can be given that the annual expense ratio will in fact be at a level less than 1½% of average net assets."

Between these two quotations was the sentence:

> "The Investment Advisory fee schedule would not be changed under the new agreement; however, the higher allowable expense ratio limitation would *benefit the Adviser* by reducing the *risk* that *some* or *all* of the Advisory fee would have to be *reimbursed* to the Fund due to an increase in rates or other expenses or changes in the average account size of the American Investors Fund shareholders." (emphasis added)

The shareholders were told about "benefit" to the Adviser, "risk" reduction, "reimburs[ment] to the Fund", the formula and the most recent net assets.

Nevertheless, the panel stated there was no ". . . indication whatever that a refund was even a remote possibility, under any set of circumstances, in 1973 and 1974 . . ." (64a)

The courts below referred to one paragraph only of the proxy statement. It is believed that the four paragraphs set forth below must be considered to determine whether the proxy statement, as a matter of law, was misleading. They read:

> "Approval of the Terms of the New Advisory Agreement
>
> "As a result of cost increases over which neither the Fund nor the Adviser can exercise control, the Fund and the Adviser have determined that the 1% annual expense ratio limitation in the current Investment Ad-

visory Agreement shall be increased to 1½%. No increase in the fees paid or payable to the Adviser is proposed. The aggregate of annual operating costs, including the fee of the Adviser, will be limited to 1½% of average monthly net assets in the contract. Heretofore, the Advisory Contract required the Adviser to reimburse the Fund to the extent that total annual expenses (exclusive of interest and taxes) exceeded 1% of average monthly net assets. Under the new agreement, no reimbursement from the Adviser would be required unless and until total annual expenses of the Fund (again, excluding interest and taxes) exceeded 1½% of average monthly net assets. The Investment Advisory fee schedule would not be changed under the new agreement: however, the higher allowable expense ratio limitation would benefit the Adviser by reducing the risk that some or all of the advisory fee would have to be reimbursed to the Fund due to an increase in rates for other expenses or changes in the average account size of American Investors Fund shareholders. No higher fees or costs would have been incurred by the Fund had the proposed new Agreement been in effect in 1972.

"The contract provides that the total expenses of the Fund (exclusive of interest and taxes but including the advisory fee) shall not be more than 1½% of the average monthly net assets of the Fund. The Board of Directors of the Fund has agreed, however, that should the Fund register its shares for sales in states which impose a more stringent expense limitation, the Adviser will reimburse the Fund for expenses above the limitation imposed by such states. The Board of Directors of the Fund and the Adviser contemplate making undertakings to certain states in which Fund sales are being made, which undertakings would re-

quire the Adviser to reimburse the Fund to the extent that total expenses of the Fund (exclusive of interest and taxes) exceed 1½% of the first $30 million and 1% of the excess over $30 million. ***However, no assurance can be given that the annual expense ratio will in fact be at a level less than 1½% of average monthly net assets.*** (Emphasis added.)

"The proposed new Agreement appears at pages 16-20 of this Proxy Statement. Approval of the new Investment Advisory Agreement could, to the extent deemed appropriate by defense counsel, be used as a defense in the Fogel Litigation described in this Proxy Statement at pages 9 and 10. All provisions of the proposed Investment Advisory Agreement are the same as those contained in the current Agreement with the exception of the effective date and the change in the expense ratio limitation.

"To be adopted, the new Agreement must be approved by a majority of directors who are not parties to such Agreement or interested persons of any such party and must be authorized by a vote of a majority of the outstanding shares of the Fund; by definition contained in the Investment Company Act of 1940 this means a vote of (a) holders of 67% or more of the shares of the Fund present if holders of more than 50% of the outstanding shares of the Fund entitled to vote at the meeting are present in person or by proxy, or (b) holders of more than 50% of the outstanding shares of the Fund entitled to vote at the meeting, whichever is less."

Despite the fact that plaintiff never contended that the Fund *ever* reimbursed the *Adviser's* expenses, despite the fact that none of the financial reports and prospectuses in evidence suggest even the possibility that any of the *Ad-*

viser's expenses were ever paid by the Fund and the practice is unknown in the industry (and would be stopped overnight by the SEC); nevertheless, the panel evinced its total misconception of this case by the untrue statements:*

> "In return, Chestnutt Corporation *received quarterly reimbursements of its expenses* . . . (emphasis added) (56a)
>
> —and—
>
> "Inflation simultaneously was causing a rapid increase in the *Adviser's expenses*" (emphasis added) (57a).

Since nothing proposed or done related to the Adviser's expenses, this Court could well order summary reversal on these sentences alone.

But going even farther, the panel disregarded the pleadings and stipulation that the 1974 contract approval was not challenged (A 171-172, 174, 180) and the Fund's *calendar year* filings for all purposes which showed that for 1974 the Fund was $399,000 below the expense ratio limitation.

The panel's immersion in federal common law of corporations to the exclusion of statutory language itself led inexorably to disregard of the Proxy Regulation first example of a prohibited misleading statement "(a) Predictions as to specific future market values on dividends." The proxy statement set forth a true formula and true total net assets. Only by "prediction" or extrapolation (a "prediction" that things will stay the same) of the specific portfolio future market values could the degree of the disclosed "benefit [to] the Adviser by reducing the risk" have been estimated.

* Respondents' counsel, as officers of the Court, cannot fail to confirm this representation.

Further, since the directors had weekly Fund detailed balance sheets, and knew that the Adviser's income was a variable dependent upon quarterly Fund assets, the four outside directors (all of whom practice a profession or have graduate degrees) knew as much about the Adviser's prospects as management.*

Common law preoccupation with the Adviser may account for the failure of the panel to refer to the Fund's minutes.

The Board of Directors, at their first of *two* meetings to discuss the advisory agreement, on May 21, 1973 discussed "The *impact* upon such an expense limitation of the decline in net assets. . . .". (Emphasis added.)

The paragraph from the minutes (Ex. 6) read:

> "A discussion of the Investment Advisory Agreement was introduced with a statement by George A. Chestnutt, Jr., regarding the maximum expense ratio which the Fund had adopted as a condition of its registration in several states. *The impact upon such an expense limitation of the decline in net assets was discussed.* The Directors instructed counsel for the Fund to discuss the problem of the maximum expense ratio with the securities commissioners of the various states requiring a maximum expense ratio and report back

* Not crucial for petition purposes, but highly misleading, was the panel's misnomer (61a, Note 13) of the Adviser's thirteen years of retained earnings of $759,564 [fully committed to real property at cost of $777,059 which is the physical facility furnished the Fund rent free under the agreements] which it erroneously described as "total current assets," failing utterly to state the *net* current assets of merely $269,957 derived by subtracting current liabilities of $484,802 from current assets of $754,759, shown on the same page. We have earlier referred to the Adviser's loss of $248,000 in 1973 alone, plus $180 to $200,000 loss in 1974.

to the Board. Further action on the Investment Advisory Agreement was put off until a later date."

It was only after counsel had personally discussed the matter in Los Angeles, and two weeks thereafter at a meeting held June 5, 1973 (Ex. 8), that the Directors approved submitting the proposal to shareholders in the proxy statement. It was at this meeting that outside Director Ulrich (presently V.-P. and Controller of Pan American World Airways), who with Arthur Andersen & Co. as a C.P.A. had devoted years to auditing other funds and advisers, presented an extensive tabulation of expenses and other facts relating to all no-load funds having assets over $100 million. (29a, Ex. 14A, 14B).

Upon remand, the damages were approximately doubled, principally by charging against the Adviser some two-thirds of a quarterly *advisory fee,* which was not paid in fact, or payable, until after the damage period. The superseding final judgment was affirmed and the appeal held "frivolous."

Reasons for Granting the Writ

This unanimous Court held in *Brunswick Corp.* v. *Pueblo Bowl-O-Mat, Inc.,* 429 U.S. 477, 97 S.Ct. 690, at 697:

> "to the contrary it is far from clear that the loss of windfall profits that would have accrued . . . even constitutes 'injury' within the meaning of §4."

This Court held that recovery "should only be for the type of loss that the claimed violation . . . would be likely to cause."

In essence, this case is no different from that of a lawyer (as fiduciary) who agrees with a group of clients

prospectively that in connection with future services, the lawyer's risk of having to bear the burden of his clients' own disbursements will be reduced. It would not be contended that the lawyer violated his duty if he failed to disclose either his own personal income or his office overhead.

But here, the Courts below, without any statutory basis, have referred to "penalizing the Adviser" (63a), in effect converting the statute into a penalty and giving the Fund a windfall.

Neither of the courts below made any attempt whatever to see if this case could possibly be fitted under "the language itself" of §10(d) of the Act or under §36(b) of the Act or whether the duty of inquiry under §15(c) expressly referred to by the trial court (but reference to which was omitted by the Court of Appeals) bore any relationship to federally mandated disbursements to third parties which was the subject of California's intrusion in interstate commerce, and upon which springboard a Pennsylvania plaintiff succeeded in invoking federal common law of corporations, contrary to the express words of the statute.

Both courts below invoked *Pepper* v. *Litton,* 308 U.S. 295 (1939), and the trial court in addition invoked *SEC* v. *Chenery Corp.,* 318 U.S. 80 (1942), without, however, quoting Mr. Justice Frankfurter's essential criteria (at 85-86):

> "But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?"

The substitution of *Pepper* v. *Litton* for the precise and specific terms of a statute is exactly what occurred in *Piper* v. *Chris-Craft*, —— U.S. ——, 97 S.Ct. 926, in *Sante Fe Industries Inc.* v. *Green*, —— U.S. ——, 97 S.Ct. 1292, and in *Du Pont* v. *Collins*, —— U.S. ——, 97 S.Ct. 2229, requiring reversal by this Court. The fact that the second appeal, after remand, was held "frivolous" even in the light of recent decisions of this Court, makes it imperative to restore the statutes of Congress, and again to extirpate federal common law of corporations.*

The inconsistency of the decisions below with this Court's decisions applying federal statutes is demonstrated briefly below.

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* As to "frivolous" we refer to the final footnote in *Chris-Craft* v. *Piper*, 516 F.2d 172, at 194 which reads:

"30. The cross-appeal by BPC, First Boston, the Piper family defendants and others may be disposed of summarily.

To the extent they claim that no damages at all should be awarded to CCI, the claim is rejected for the reasons set forth above in this opinion.

To the extent they claim that our previous decision in *Chris-Craft II* was erroneous with respect to the issues of standing, liability and causation, we reject such claims as frivolous. Aside from the original panel decision of this Court on March 16, 1973, 480 F.2d 341, which rejected these precise claims, the panel unanimously denied the cross-appellants' petition for rehearing (after amending the opinion as state dabove, note 7 *supra*), 480 F.2d at 407; the cross-appellants' petition for rehearing en banc was denied, no judge having requested an en banc poll, 480 F.2d at 407; and the Supreme Court denied certiorari without dissent, 414 U.S. 910 (1973).

We rest on our previous opinion because it represents the law of the case, Zdanok v. Glidden Company, Durkee Famous Foods Division, 327 F.2d 944, 950-53 (2 Cir.), cert. denied, 377 U.S. 934 (1964); because we find no conflict between *Chris-Craft II* and our intervening decisions of Lanza v. Drexel & Co., 479 F.2d 1277, 1306 n. 98 (2 Cir. 1973) (en banc), and Gerstle v. Gable-Skogmo, Inc., 478 F.2d 1281, 1299 n. 17, 1301 n. 20 (2 Cir. 1973), cited by cross-appellants; and because we are satisfied with it. United States v. Certain Property, Etc., 344 F.2d 142, 144 (2 Cir. 1965).

1. The courts below deprived the Adviser of specific statutory rights, contrary to *Ernst & Ernst* v. *Hochfelder*, 422 U.S. 185 (1976). The courts below paid no attention that it was "stipulated to be true" that "the fund is an open-end investment company incorporated in New York of the no-load variety as described in Section 10(d) of the Act . . .". This specific and precise statutory provision is the only provision in the Act which mentions any specific advisory fee or types of expenses. It goes so far as to permit a *single* outside director, if the specific 1% advisory fee is not exceeded and the itemized expenses precisely specified are not borne by the no-load company. There was neither contention nor proof contrary to such stipulated fact, not a penny of expenses was challenged, and the actual advisory fees of 0.57% and 0.61% were only slightly more than half the statutorily recognized and permissible 1%. (A-29-A-30, Pretrial Order ¶1)

The long legislative history of the 1970 Amendments to the 1940 Act commenced with an SEC report "Public Policy Implications of Investment Company Growth (H.R. No. 2337, 89th Cong. 2nd Sess. 1966). The special niche of "no-load" funds was referred to, particularly pages 52-59, and at page 53 the Commission stated:

> "From the small investors point of view the sales load is by far the principal cost of a mutual fund investment. Most mutual fund investors are small investors, and the 8.5% sales load they normally pay is—assuming that the net assets value of the Fund's shares does not change—almost 19 times the prorated share of the customary annual advisory fee of ½ of 1%."

Thus, even if under federal corporate common law there were "constructive receipt" of the payments to third parties (i.e., printing, postage, bank charges), the aggregate

would never have approached what the Adviser could have charged as a matter of statute law *for its advisory fee alone.*

Congress, being advised of the enormous bargain of no-load funds, reenacted the section, changing the term "affiliated" to "interested" person. Pennsylvania plaintiff can hardly acquire a "Dartmouth College" veto power over changes in California policy, or the exercise of express federal statutory rights.

2. Even if it were assumed that §36(b), which was the sole basis for finding liability, could as a more general provision supplant §10(d) which is the only provision specifically referring to a no-load fund advisory fee and its expenses, the very terms of §36(b), the language itself, cannot possibly be applied.

In contrast to §36(a) which includes authorization to the SEC to sue for injunction when certain persons are ". . . about to engage . . . in a breach of fiduciary duty involving personal misconduct . . .", §36(b)(3) limits liability in a shareholder's suit to a "recipient of compensation or payments." The complaint does not even attack "compensation," nor did plaintiff even attempt any burden of proof required under §36(b)(1) with respect to "compensation". The adviser was not a "recipient" of any other "payments".

The "language itself" of the statute cannot permit damage under §36(b), and as the Court stated in *Piper, supra,* 97 S.Ct. at 946, Note 23, ". . . focus upon the precise goals [is] . . . an indispensable inquiry under *Borak.*"

Thus, under the *only* provision of the statute granting an *express* right to sue, and the sole provision under which damage was awarded, she neither alleged a cause of action nor proved damage.

3. The Courts below permitted plaintiff to *supplant* the SEC, not *supplement* it. The SEC could not sue. For the SEC to bring an action here, it would be necessary for the Commission to attack and *recant* its own proscribed example of a misleading statement, "Predictions as to specific future market values or dividends", as well as the specific sentence injected at its request and approved by its Branch Chief: "No higher fees or costs would have been incurred by the Fund had the proposed new Agreement been in effect in 1972", which the panel found misleading.

Surely, the Commission could not attack its own Regulation of general applicability, and its own words! Any suit would be dismissed on the face of the complaint. The SEC cannot "undermine" its own public "enforcement".

In *Piper,* the first four paragraphs of Part IV (97 S.Ct. at 941) carefully italicized the limitations on implied causes of action—"' . . . *a necessary supplement to Commission action*'". It is clear that there must be both "necessity" and "supplement" before there can be implication of a private cause of action.

There can be nothing to "supplement" where the SEC could not sue. For plaintiff to have any standing in court it must be held that the Regulation under which the SEC could *not* sue was so patently invalid that it was necessary for a private party to *supplant* the Commission, not supplement it.

The known existing fact of total net assets of $150,102,469 was set forth—without prediction as to "future market values." Defendants' Exhibit EE on remand duplicates in part the information in Exhibit 15, upon which the trial judge made his computations of "average net assets" for 1973 of $166,058,784. Not only did the directors know the net assets from receipt of *weekly* balance sheets, but when

the directors met on May 21, 1973 and "The impact upon such an expense limitation of the decline in net assets was discussed", Exhibit EE shows that the average net assets were $179,894,657, which would have turned out to be $138,160 *below* the limitation.

Indeed, ought defendants to have violated the proxy Regulation by too gloomy a prediction as to "specific future market values" and stampeded the shareholders out of fear? See *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723.

In the light of Chestnutt's widely published market letter of May 16, 1973, which all directors had [Exhibit F] stating:

> "In this case we believe we are in the final stages of an intermediate term decline that may have bottomed but, if not, is about to end.",

no such gloomy "predictions as to future market values" would have truly stated the Adviser's best judgment.

When the directors again met on June 5, 1973, and when the June 14, 1973 total net assets were stated in the proxy statement to be $150,102,469, Exhibit EE shows that on both dates expenses continued to be well below the limitation until the successful Arab Oil Embargo which shattered securities prices in the remaining two months and the following year.

Properly analysed, it is plain that the "primary component of the rebate formula", taken from the reports published to shareholders (summarized Ex. B, p. 3), was the 70% increase in postage, bank charges, printing, etc. during a 15% decline in assets. Defendants cannot be charged with inventing inflation and successfully concealing the invention from shareholders.

Nor can defendants be held liable for failing to violate the proxy Regulation by first predicting the Oil Embargo and then predicting "specific future market values."

5. The courts below have substituted a common law *mystique* for "the unique characteristic of mutual funds." *U.S.* v. *Cartwright,* 411 U.S. 546, 548 (1973). Plaintiff was not deceived. She sued. Neither she nor any other shareholder, redeeming or continuing, have had their total investment affected by a red cent. Looking solely at the corporate entity, whose stockholders have approved the agreement four times, petitioner is entitled to the holding in *Perma-Life Mufflers, Inc.* v. *International Parts Corp.,* 392 U.S. 134, 140 (1968):

> "The possible beneficial byproducts of a [violation] . . . can *of course* be taken into account in computing damages." (emphasis added).

Congress labored nearly five years to create an *express* cause of action in §36(b) of the 1940 Act. The baleful and overwhelmingly important result of the decisions below is to permit an *implied* cause of action under the 1934 Act to obliterate the specific safeguards set up by Congress to govern the express cause of action under the 1940 Act. This result applying to the $50 billion mutual fund industry with its many hundreds of funds and advisers plows chaos in the field so deliberately sown by Congress. The mischief is compounded where, as here, the SEC would not impeach its own words and its own Regulation in an expressly granted cause of action—where the remedy would be a new vote now affirmatively taken four times—but an uninjured shareholder has been permitted by implication to usurp the function and sue for money damage where the body of stockholders and the Fund as a corporate entity have continued to benefit from prospective services

and cheerfully accept tens of millions of dollars of appreciation. Since the SEC could not sue and there was nothing to supplement, one hardly needs exculpation for failure to "predict specific future market values" of the portfolio under the express terms of §38(c) of the 1940 Act granting absolution for ". . . any act done or omitted in good faith conformity with any rule, regulation or order of the Commission."

Rather, the focus should be upon ". . . the specific congressional responses to this problem." *Du Pont* v. *Collins*, *supra*, 97 S.Ct. at 2233. One cannot imagine a more specific response than §36(b). While *du Pont* involved §17, a closed end company and the administrative process, it exactly complements *Cartwright*, *supra*, and its substance is instructive.

Du Pont holds that unless there is detriment to the net asset value per share, it is irrelevant that an affiliated person is substantially benefitted.

In referring to the "unique characteristic of mutual funds" in *Cartwright* (411 U.S. at 548), the Court held, since a redeeming shareholder could not obtain any *premium* over the net asset value per share, a tax regulation was invalid which required valuation at the "asked" price of a load fund.

The *Cartwright* case splits Poe's Raven's word into "Never More".

The *du Pont* case holds "Never Less".

These two decisions are utterly realistic, as well as binding authority. Customary concepts, applicable in other contexts have no application whatever. For example, a holder of an open-end investment company, especially a no-load fund where there was no ticket of admission or

conceivable *detriment* in becoming a shareholder, does not patiently wait for timber to mature. No aspect of the considerations involved in *SEC* v. *Texas-Gulf Sulphur Co.*, 401 F.2d 833 (1968) comes into play. No shareholder earnestly hopes for a better recognition of the "price-earnings ratio". One cannot imagine a "tender offer" for open-end investment company shares above the "market", the net asset value per share.

The present and the future are identical. Actuality and expectation are the same. Valuation is known instantly in the daily papers.

Prediction has no place.

The present plaintiff sued, set back, waited and prospered. Had she sold upon receipt of the proxy statement; upon the first occasion of shareholder approval; upon the second occasion of sharehlder approval; upon the third occasion of shareholder approval; or upon the fourth occasion of shareholder approval—the net asset value of her shares would not be, and was not, changed by any shareholder action.

The action of the shareholders was *prospective* only. It had no immediate effect whatever. Whether there could be any actual effect in the future could not be known until unknown future events transpired. Nothing in law or equity gives a shareholder a roving editorial commission to alleviate any "anxiety", whether immediate, contingent or continuing. *Rondeau* v. *Mosinee Paper Co.*, 422 U.S. 49, 59. This suit is for chagrin.

The long overdue constitutional recognition of "commercial free speech" must require as a minimum, as in defamation, an immediate impact or injury to a plaintiff. An induced reliance, action or forebearance, and actual detriment must be a bare minimum to show that "damages in

some amount susceptible of expression in figures resulted." *Keogh* v. *Chicago & Northwestern Ry. Co.*, 260 U.S. 156, 165 (1922). This could not be predicted and did not happen.

Prospective shareholder action with respect to unknown and unpredictable future circumstances has no impact, and hence no possible injury, since the net asset value per share is not affected and cannot possibly be affected until the unknown future events do occur.

A proxy statement is not a verbal timebomb.

A statement cannot be "material" with respect to an "open-end" investment company, unless it would have a *present* tendency to affect the net asset value per share.

Plaintiff had ample warning. She could have had immediate *"appraisal"* by redemption before the vote, and she could have had immediate *"appraisal"* by redemption after the vote, or on any day subsequent thereto—all without any effect on her net asset value per share. If she "feared" that there might be an adverse effect, she could have redeemed on apprehension, home free on "fear" for the future. Her *total* investment was unaffected by a penny.

Summary

This case, already cited as precedent in cases outside the large mutual fund industry, cannot be reconciled with *TSC Industries* v. *Northway, supra.* Far more important, however, is its failure to apply the plain meaning of the language of a statute which Congress specifically directed at particular subjects. The common law substitution for statutory words demonstrates that lower courts need further guidance from this Court, lest its decisions, particularly on the securities statutes in recent years, be vitiated. Properly viewed, this action is not a case or controversy

in the constitutional sense, unless §36(b) can be applied as a penalty, which is exactly what was done below.

CONCLUSION

For all the foregoing reasons it is respectfully submitted that the writ should be granted and the decision below should be reversed.

Respectfully submitted,

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Appendix

APPENDIX A

Statutory Appendix

Section 10(d), Investment Company Act of 1940, 15 U.S.C. § 80a-10(d)

(d) Notwithstanding subsections (a) and (b) (2) of this section, a registered investment company may have a board of directors all the members of which, except one, are interested persons of the investment adviser of such company, or are officers or employees of such company, if—

(1) such investment company is an open-end company;

(2) such investment adviser is registered under subchapter II of this chapter and is engaged principally in the business of rendering investment supervisory services as defined in subchapter II;

(3) no sales load is charged on securities issued by such investment company;

(4) any premium over net asset value charged by such company upon the issuance of any such security, plus any discount from net asset value charged on redemption thereof, shall not in the aggregate exceed 2 per centum;

(5) no sales or promotion expenses are incurred by such registered company; but expenses incurred in complying with laws regulating the issue or sale of securities shall not be deemed sales or promotion expenses;

(6) such investment adviser is the only investment adviser to such investment company, and such investment adviser does not receive a management fee ex-

ceeding 1 per centum per annum of the value of such company's net assets averaged over the year or taken as of a definite date or dates within the year;

(7) all executive salaries and executive expenses and office rent of such investment company are paid by such investment adviser; and

(8) such investment company has only one class of securities outstanding, each unit of which has equal voting rights with every other unit.

Aug. 22, 1940, c. 686, Title I, § 10, 54 Stat. 806; Dec. 14, 1970, Pub.L. 91-547, § 5, 84 Stat. 1416.

Section 15(c), Investment Company Act of 1940, 15 U.S.C. § 80a-15(c)

(c) In addition to the requirements of subsections (a) and (b) of this section, it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party, cast in person at a meeting called for the purpose of voting on such approval. It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any

contract whereby a person undertakes regularly to serve or act as investment adviser of such company.

Aug. 22, 1940, c. 686, Title I, § 15, 54 Stat. 812; Dec. 14, 1970, Pub.L. 91-547, § 8, 84 Stat. 1419.

Section 36(b), Investment Company Act of 1940, 15 U.S.C. § 80a-35(b)

Compensation or payments as basis of fiduciary duty; civil actions by Commission or security holder, burden of proof; judicial consideration of director or shareholder approved; persons liable; extent of liability; exempted transactions; jurisdictions; finding restriction

(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plain-

tiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a—17 of this title, or rules, regulations, or orders thereunder, or to sales loads for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 80a—9 and 80a—48 of this title, section 78*o* of this title, or section 80b—3 of this title, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

Aug. 22, 1940, c. 686, Title I, § 36, 54 Stat. 841; Dec. 14, 1970, Pub.L. 91-547, § 20, 84 Stat. 1428.

APPENDIX B

Opinion of U.S.D.C., E.D. Penn., July 13, 1973

Mildred Galfand, on behalf of herself and on behalf of American Investors Fund, Inc.,

Plaintiff,

v.

George A. Chestnutt, Jr., and Chestnutt Corporation,

Defendants,

American Investors Fund,

Nominal Defendant.

Civ. A. No. 73-1516.

United States District Court,
E. D. Pennsylvania.
July 13, 1973.

Richard A. Ash, Philadelphia, Pa., for plaintiff.

H. Laddie Montague, Jr., Philadelphia, Pa., for defendants.

Memorandum

Broderick, District Judge.

This is a shareholder derivative action filed on July 6, 1973. A hearing was held on July 11, 1973 on plaintiff's request for a preliminary injunction restraining the defendant, American Investors Fund, Inc. (Fund) from conducting its annual meeting scheduled for July 17, 1973 in Greenwich, Connecticut and barring the use of the proxies.

The defendant filed on July 11, 1973 a motion to transfer this action to the United States District Court for the Souhern District of New York, pursuant to 28 U.S.C. § 1404(a).

The complaint alleges that defendants George Chestnutt and Chestnutt Corporation, the Fund's investment advisor, have entered into a self-dealing investment advisory agreement which is unfair to the shareholders and that the proxy statements requesting shareholder approval of the agreement conceal the real nature of the proposal.

The plaintiff claims that the proposed investment advisory contract results from a violation of the fiduciary duty set forth in Section 36(b) of the Investment Company Act 15, U.S.C. § 80a-35(b). Plaintiff further alleges that as part of the plan the defendant, George A. Chestnutt, Jr., a citizen of Greenwich, Connecticut and President of the Fund and the President of Chestnutt Corporation, utilized his control of the other directors of the Fund by virtue of his 47% ownership of the stock of the Fund to induce the directors to breach their fiduciary duties by accepting the proposed new investment advisory agreement which has been proposed for ratification at the annual meeting on July 17, 1973. The plaintiff alleges that the proxy material is false and misleading in that it states:

> *as a result of cost increases over which neither the fund nor the advisor can exercise control,* the Fund and the advisor have determined that the 1% annual expense ratio limitation in the current Advisory Agreement shall be increased to 1½%. (Emphasis added)

Pursuant to the plaintiff's request for a preliminary injunction to enjoin the defendants from conducting the annual meeting scheduled for July 17, 1973, and the de-

fendant's motion for a change of venue, this Court scheduled a hearing for July 11, 1973. Due to the fact that the annual meeting is scheduled for July 17, 1973, this Court reserves decision on the defendant's motion for a change of venue pursuant to 28 U.S.C. § 1404(a) and herein decides the plaintiff's motion for a preliminary injunction.

Plaintiff's first contention in support of her motion for a preliminary injunction is that the proxy solicitation material being used to obtain shareholder approval for the proposed modification of the investment advisory agreement violates Rule 14a-9 of the Securities and Exchange Commission in that it falsely states that the change is proposed "as a result of cost increases over which neither the Fund nor the advisor can exercise control." The plaintiff's second ground is that the directors have breached their fiduciary duties in proposing the modification of the agreement imposed by Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b), as it is a self-enrichment proposal which is contrary to the best interests of the Fund.

The only evidence introduced by the plaintiff in support of the preliminary injunction motion is the deposition of the defendant, George Chestnutt, Jr., the Fund's April 30, 1973 prospectus, the Fund's proxy statement for the July 17, 1973 meeting, and the annual report of the Fund.

The Fund's proxy solicitation statement for the July 17, 1973 annual meeting provides as follows, in pertinent part:

Approval of the Terms of New Advisory Agreement

> As a result of cost incrases over which neither the Fund nor the Adviser can exercise control, the Fund and the Adviser have determined that the 1% annual expense ratio limitation in the current Investment Advisory Agreement shall be increased to 1½% of average monthly net assets in the contract. Heretofore, the Advisory Contract required the Adviser to reimburse the Fund to the extent that total annual expense (exclusive of interest and taxes) exceeded 1% of average monthly net assets. Under the new agreement, no reimbursement from the Adviser would be required unless and until total annual expenses of the Fund (again, including interest and taxes) exceeded 1½% of average monthly net assets. The Investment Advisory fee schedule would not be changed under the new agreement; however, the higher allowable expense ratio limitation would benefit the Adviser by reducing the risk that some or all of the advisory fee would have to be reimbursed to the Fund due to an increase in rates for other expenses or changes in the average account size of American Investors Fund shareholders. No higher fees or costs would have been incurred by the Fund had the proposed new Agreement been in effect in 1972.
>
> The contract provides that the total expenses of the Fund (exclusive of interest and taxes but including the advisory fee) shall not be more than 1½% of the average monthly net assets of the Fund. The Board of Directors of the Fund has agreed, however, that should the Fund register its shares for sale in states which impose a more stringent expense limitation, the Advisor will reimburse the Fund for expenses above the limitation imposed by such states. The Board of Directors of the Fund and the Advisor contemplate making undertakings to certain states in which Fund

sales are being made, which undertakings would require the Adviser to reimburse the Fund to the extent that total expenses of the Fund (exclusive of interest and taxes) exceed 1½% of the first $30 million and 1% of the excess over $30 million. However, no assurance can be given that the annual expense ratio will in fact be at a level less than 1½% of average monthly net assets.

The proposed new Agreement appears as pages 16-20 of this Proxy Statement. Approval of the new Investment Advisory Agreement could, to the extent deemed appropriate by defense counsel, be used as a defense in the Fogel Litigation described in this Proxy Statement at pages 9 and 10. All provisions of the proposed Investment Advisory Agreement are the same as those contained in the current Agreement with the exception of the effective date and the change in the expense ratio limitation.

To be adopted, the new Agreement must be approved by a majority of directors who are not parties to such Agreement or interested persons of any such party and must be authorized by a vote of a majority of the outstanding shares of the Fund; by definition contained in the Investment Company Act of 1940 this means a vote of (a) holders of 67% or more of the shares of the Fund present if holders of more than 50% of the outstanding shares of the Fund entitled to vote at the meeting are present in person or by proxy, or (b) holders of more than 50% of the outstanding shares of the Fund entitled to vote at the meeting, whichever is less.

The Fund's proxy solicitation statement also provides the information concerning the officers and directors of the

Fund and the Chestnutt Corporation and their financial interests in both the Fund and Advisor Corporation. Mr. Chestnutt in his deposition explained the proposed change as follows:

> I pointed out first of all that we were in a severe bear market, the extent of which could not be positively predicted, and it was possible that the fund would have further shrinkage in assets. I pointed out that simultaneously with this bear market in stocks we were undergoing one of the greatest inflations that this country has seen since at least going back to the end of World War I, and that costs of the fund were basically out of control. All the Bank of New York, for example, had to do was announce a price increase for a certain function and there was nothing we could do about it, and that inevitably, with the inflation rate out of control, expenses were going up and if contrarily the market kept going down it would be inevitable that somewhere down the road, if things didn't change, that it would reach the unfair proportions of perhaps bankrupting the adviser, or causing the adviser to have to completely get out of the business; that there was a very strong possibility that way down the line something like that could happen, and that I felt that the expense limitation was unfair and I also pointed out that most of the States that I knew about that had originally imposed the one percent limitation, had been convinced by various funds and managements of those funds that the limitation was grossly unfair and had relaxed their rules accordingly. And that specifically California had done so to the extent of allowing that limit—the one percent limitation to apply to only the excess over the first thirty million dollars, and that

> we could still get in all of the States that were important if we conformed our contract with what those States had already recognized was fair and equitable, and that we should proceed to do it. That was my presentation of the board overall picture, and a discussion took place among all of the directors, and I do not recall any of them seriously questioning the validity of the basic fundamentals that I presented.

Information prepared by officers of the Fund and read into the record during the deposition of Mr. Chestnutt shows that while the net assets of the Fund decreased by 15% during the period from 1967 to 1972, the Fund's expenses, excluding the advisory fee, increased by 70% or from $508,340 to $865,010.

The standards for the issuance of a preliminary injunction require the moving party to demonstrate a reasonable probability of eventual success on the merits and irreparable injury *pendente lite*. This Court has broad discretion, since its task involves weighing the benefits and burdens that the injunction will have on each of the parties and the public. Penn Galvanizing Company v. Lukens Steel Co., 468 F.2d 1021 (3rd Cir. 1972).

The Plaintiff contends that the directors have breached their fiduciary duty to the Fund by proposing the modification of the investment advisory agreement. The plaintiff claims that the proposed Agreement is not fair and results from self-dealing, contrary to the best interest of the Fund. The plaintiff also contends that the proxy material is false and misleading in that it states that the proposed change in he advisory agreement results from cost increases over which neither the Fund nor the advisor can exercise control.

There is insufficient evidence in the record to enable the Court to find, with reasonable probability, that plaintiff will succeed in proving either contention at the trial on the merits. Section 36(b) of the Investment Company, 15 U.S.C. § 80a-35(b) provides, in pertinent part:

> (b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person.

Section 36(b)(1) of the Act, 15 U.S.C. § 80a-35(b), provides:

> It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

In considering transactions where fiduciaries have conflicts of interest, such as Mr. Chestnutt and the Chestnutt

Corporation in the instant case, such transactions will be upheld only if hey are determined to be fair. Pepper v. Litton, 308 U.S. 295, 60 S.Ct. 238, 84 L.Ed. 281 (1939). The test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain; there must be a reasonable proportion between benefits and burdens, and there must be full disclosure. Pepper v. Litton, *supra;* Globe Woolen Co. v. Utica Gas & Electric Company, 224 N.Y. 483, 490, 121 N.E. 378, 380 (1918). There is not sufficient credible evidence in this record to enable this Court to find a reasonable probability that the plaintiff will succeed in proving that the proposed agreement is unfair, or that there was not a full disclosure.

This record, at this stage, contains little, if any, evidence that the proposed Agreement is "unfair." The proxy statement sets forth the benefit of the new agreement to the Adviser and the burden to the Fund. As stated by Chief Judge Lord in Allen v. Penn Central Company, 350 F.Supp. 697, 702 (E.D. Pa. 1972):

> "It is easy to find small errors and trivial omissions in any proxy sttaement, but '[r]easonable latitude in this area is important if nit-picking is not to become the name of the game.' Kohn v. American Metal Climax, Inc., 458 F.2d 255, 267 (C.A. 3, 1972)."

The real test is whether the proxy statement "when read as a whole by a reasonable shareholder, conceals the real nature of the proposal for which the shareholder's voate is being sought." There is not sufficient credible evidence in this record to enable this Court to find a reasonable probability that the Plaintiff will succeed in proving that the proxy material conceals the nature of the proposal to the

shareholders; and that it does not convey "an honest and candid picture of the proposal." Allen v. Penn Central Company, *supra,* at p. 702.

The Court, therefore, concludes that the plaintiff has not established the first prerequisite for the issuance of a preliminary injunction—a reasonable probability of eventual success on the merits.

The second requirement for the issuance of preliminary relief is irreparable injury *pendente lite.* Plaintiff has failed to demonstrate any threat of irreparable harm if the shareholders' meeting goes forward on July 17, 1973, and the new advisory agreement, which does not become effective until September 1, 1973, is approved. Injury cannot be considered irreparable "unless plaintiff demonstrates that its *legal remedies* are *either inadequate or impracticable.*" A.L.K. Corporation v. Columbia Pictures Industries, Inc., 440 F.2d 761, 763 (3d Cir. 1971). (Emphasis added.)

If the plaintiff ultimately prevails at the trial on the merits in having the new agreement declared void, plaintiff has an adequate legal remedy in damages. The new agreement does not change the old agreement except in one respect: it increases the percentage of allowable expenses from 1% to 1½%. Thus, the harm to plaintiff only occurs if expenses exceed 1%, and if the new agreement is void the defendant, Chestnutt Corporation, would be liable to the Fund in damages for that excess. Accordingly, the plaintiff has an adequate remedy at law.

In balancing the benefits and burdens that granting or denying the injunction will have on each of the parties and the public, the record shows that $65,000 has already been expended in connection with the Fund's annual meeting scheduled for July 17, 1973. Should that meeting be en-

joined, that money will be wasted. In contrast to the potential waste of substantial monies already expended, there is no prejudice to plaintiff and the other shareholders if the annual meeting proceeds as scheduled. To the extent action taken at the annual meeting may result in a voidable contract, damages, if any, may be recovered from the defendants.

In conclusion, the plaintiff has not demonstrated a reasonable probability of eventual success on the merits or irreparable injury *pendente lite*. The plaintiff has also failed to demonstrate that the harm suffered by the plaintiff and the shareholders if the injunction is denied outweighs the burdens that the defendants will suffer if the injunction is granted. The Court, therefore, concludes that a preliminary injunction is inappropriate.

This Memorandum and Order shall constitute the Court's findings of fact and conclusions of law, pursuant to Rule 52(a), Federal Rules of Civil Procedure.

APPENDIX C

Opinion of U.S.D.C., E.D. Penn., Aug. 16, 1973

MILDRED GALFAND et al.

v.

GEORGE A. CHESTNUT et al.

UNITED STATES DISTRICT COURT,
E. D. Pennsylvania, Aug. 16, 1973.

MEMORANDUM AND ORDER

BRODERICK, District Judge.

This matter is before the Court on the motion of the defendants to transfer the above-captioned case to the United States District Court for the Southern District of New York, pursuant to 28 U.S.C. § 1404(a). The complaint in this shareholder derivative action filed on July 6, 1973 alleges that the defendants, George Chestnutt and Chestnutt Corporation, the defendant Fund's investment advisor, have entered into a self-dealing investment advisory agreement which is unfair to the shareholders of the defendant Fund. The complaint also alleges that the proxy statements of the Fund requesting shareholder approval of the investment advisory agreement are false and misleading. On July 11, 1973 this Court held a hearing on the plaintiff's motion to enjoin the Fund's July 17, 1973 annual meeting and the defendants' motion to transfer this action to the United States District Court for the Southern District of New York. By Memorandum and Order of July

13, 1973, 363 F.Supp. 291 this Court denied plaintiff's motion to enjoin the Fund's annual meeting. We shall now determine the motion to transfer.

For the reasons hereinafter stated, we feel compelled to transfer this case to the United States District Court for the Southern District of New York. The motion to transfer is governed by 28 U.S.C. § 1404(a), which provides in pertinent part:

> (a) For the convenience of parties and witnesses, in the interest of justice, a district court may transfer any civil action to any other district or division where it might have been brought.

It is not disputed that this action could have been brought in the Southern District of New York. See 15 U.S.C. §§ 78aa, 80a-43.

In determining whether this case should be transferred to the Southern District of New York, we note that the only connection which exists between any of the parties or the acts complained of and this District is that Richard A. Ash, Esq., the plaintiff's attorney, and Marvin F. Galfand, Esq., her son and business advisor, both maintain offices in this District. The affidavit submitted by the defendants indicates that all of the relevant transactions which are the basis for the complaint occurred in either New York or Greenwich, Connecticut. None of the defendants maintains an office in or resides in the Eastern District of Pennsylvania; they all reside, principally transact business, and maintain their principal places of business in New York and Greenwich, Connecticut. All of the witnesses who might be called upon to testify in this action, including the plaintiff, reside in either New Jersey, Connecticut or New York, and all the records of the Fund and the Chestnutt

Corporation are located in Connecticut or New York. Consequently, it seems clear that the convenience of the witnesses and the convenience of the defendants are best served by transferring this case to the Southern District of New York, which is the focal point of all the transactions complained of by plaintiff and is the place where the plaintiff purchased her shares.

In deciding whether to transfer the instant case, we are not unmindful that normally the decision of the plaintiff in choosing a forum should be given substantial weight. City of Philadelphia v. Emhart Corp., 317 F.Supp. 1320 (E.D.Pa.1970); Clendenin v. United Fruit Co., 214 F.Supp. 137 (E.D.Pa.1963). However, in a shareholder derivative action plaintiff's choice of forum is not afforded the same weight as in other actions. Harris v. American Investment Co., 333 F.Supp. 325 (E.D.Pa.1971); Underberg v. Selected American Shares, Inc., CCH Fed. Securities Law Reporter, ¶93, 254 (S.D.N.Y.1971); Wibau v. American Hoist & Derrick Co., 293 F.Supp. 273, 275 (S.D.N.Y.1968). In this case, the sole benefit to the plaintiff in having her suit in this district is that her son acts as her agent and business manager and that she is represented by Philadelphia counsel. The plaintiff herself is a resident of Atlantic City, New Jersey, which is almost equally convenient to both the United States District Court for the Southern District of New York and the United States District Court for the Eastern District of Pennsylvania. The convenience of counsel has never been a controlling factor on a motion to transfer, Triangle Industries, Inc. v. Kennecott Copper Corp., 325 F.Supp. 150 (E.D.Pa.1971). Similarly, this court does not feel that the convenience of plaintiff's son (who, incidentally, deserves great credit for his interest in his mother's affairs) should be given such weight as to prevent the transfer.

In deciding a 1404(a) motion, the moving party must sustain its burden of showing that the statutory considerations are satisfied by a preponderance of facts. Biedrzycki v. Alcoa Steamship Co., 191 F.Supp. 895 (E.D.Pa.1961). The Court finds that the defendants have sustained this burden, and that a transfer to the Southern District of New York would be for the convenience of the parties and in the interests of justice. Plaintiff's reliance on Girsh v. Jepson, 355 F.Supp. 1104 (E.D.Pa.1973) is misplaced. In *Girsh*, a securities law class action, in which at least one plaintiff resided in the Eastern District, the Court denied a transfer to the Central District of California as it would merely shift the burden of inconvenience from the defendants to the plaintiffs, who would have had to supervise litigation at a distance over 3,000 miles or incur extraordinary expense and inconvenience of relocation. In the instant case, however, both forums are convenient to the plaintiff, and the Southern District of New York is more convenient for the defendants and the witnesses.

The decision of this Court in Professional Adjusting Systems of America, Inc. v. General Adjustment Bureau, Inc., 352 F.Supp. 648 (E.D.Pa.1972) is dispositive of the transfer issue in the instance case. Therein, as here, plaintiff had no relevant contacts in the Eastern District of Pennsylvania. Moreover, unlike this case, the defendant therein had five district offices within this forum; the defendants herein have none. The facts of the case fall squarely within the *Professional Adjusting* opinion. Moreover, in that case, an anti-trust suit, the plaintiffs' choice of forum was given greater weight. As previously noted, in a shareholder derivative action the plaintiff's choice of forum is not afforded the consideration it can expect in other types of actions.

APPENDIX D

Opinion of U.S.D.C., S.D. New York, July 23, 1975

MILDRED GALFAND, on behalf of herself and on behalf of American Investors Fund, Inc.,

Plaintiff,

v.

GEORGE A. CHESTNUTT, JR., and Chestnutt Corporation,

Defendants,

and

American Investors Fund, Inc.,

Nominal Defendant.

No. 73 Civ. 3849.

United States District Court,
S. D. New York.
July 23, 1975.

Supplemental Findings and Conclusions
Nov. 10, 1975.

Kreindler & Kreindler, New York City, for plaintiff.
Rogers Hoge & Hills, New York City, for defendants.

FINDINGS AND CONCLUSIONS

BRIEANT, District Judge.

This shareholder's derivative action was commenced on July 6, 1973 in the United States District Court for the Eastern District of Pennsylvania, seeking a preliminary

injunction to retrain American Investors Fund from conducting its annual shareholders meeting set for July 17, 1973.

Plaintiff owns 86 whole shares of American Investors Fund, a New York corporation ("AIF" or the "Fund"), an open-end no-load mutual fund registered under the Investment Company Act of 1940 (15 U.S.C. § 80a-1, *et seq.*, the "Act").

In addition to the Fund itself, defendants are Chestnutt Corporation, a Connecticut corporation, which is AIF's investment adviser, and George A. Chestnutt, Jr., President and Director of the Fund and President, Director and owner of 47% of the shares of the adviser.

This Court has subject matter jurisdiction pursuant to 15 U.S.C. § 80a-35(b).

On July 11, 1973, the Honorable Raymond J. Broderick, United States District Judge, Eastern District of Pennsylvania, held a hearing on plaintiff's motion for an injunction. On the same day, defendants moved to transfer the action to this Court, pursuant to 28 U.S.C. § 1404(b). On July 13, 1973, Judge Broderick denied plaintiff's motion for a preliminary injunction. [Decision reported at 363 F.Supp. 291 (E.D.Pa. 1973)]. The evidence presented in support of plaintiff's motion was limited (see 363 F.Supp. p. 293); on the basis of the sparse record before him Judge Broderick held (363 F.Supp. p. 296):

> "The Court, therefore, concludes that the plaintiff has not established the first prerequisite for the issuance of a preliminary injunction—a reasonable probability of evenutal success on the merits."

Subsequently, Judge Broderick granted defendants' motion for change of venue to this Court. [Decision reported at 363 F.Supp. 296.]

On June 21, 1973, proxy solicitation materials for the annual shareholders' meeting on July 17, 1973 were mailed by management to AIF's shareholders Proxies were solicited and shareholder approval sought, *inter alia*, for a new contract between the Fund and its investment adviser, Chestnutt Corporation. The new contract was intended to replace a prior contract dated as of September 1, 1972 (Ex. 4, hereinafter referred to as the "old agreement"), which had not yet expired. The Fund and its adviser had an established custom and practice of executing two year agreements which were replaced annually, a year prior to the expiration date.

The adviser's fees were unchanged by the new agreement. The only change proposed was an increase in the "expense ratio limitation" from 1% to 1½%. Under paragraph 9 of the old agreement, the adviser was required to reimburse the Fund, up to the amount of its fee for the year, to the extent certain expenses, together with the fee, exceeded 1% of the Fund's average monthly net assets (see paragraph 9, quoted in full, *infra*, p. 1331).

Plaintiff claims Mr. Chestnutt influenced the other Fund directors improperly to have their expense ratio increased to 1½%, and did so solely for the benefit of the adviser and contrary to the interests of the Fund, to forestall an anticipated rebate of the fee during the year 1973, all in violation of 15 U.S.C. § 80a-35(b).[1]

Plaintiff also claims defendants made false and misleading statements in the proxy materials to obtain share-

[1] That statute reads in pertinent part as follows:

"(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid

holder approval of the change, in violation of 15 U.S.C. § 80a-20(a)[2] and Rule 14a-9[3] [17 C.F.R. § 240.14a-9].

The proxy materials (Ex. 1) state that the expense ratio limitation increase was sought because of rising costs, which neither the Fund nor its adviser could control. Plaintiff claims this is false. The proxy materials also state that no rebate would have been due the Fund had the 1½% expense ratio limitation been in effect in 1972. Plaintiff claims this statement is incomplete and misleading. With the market value of net assets declining and an expense

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by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by . . . a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments . . . ."

[2] 15 U.S.C. § 80a-20(a) reads as follows:

"It shall be unlawful for any person, by use of the mails or any means or instrumentality of interstate commerce or otherwise, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security of which a registered investment company is the issuer in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

[3] Rule 14a-9 reads as follows:

"(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading."

ratio limitation of 1% of the Fund's net asset value, the Fund most likely would have been entitled to a refund of a portion of the adviser's fees for 1973. Plaintiff contends the shareholders should have been told a change to a 1½% limitation would result in a loss of that foreseeable refund.

The AIF annual meeting was held as scheduled on July 17, 1973 and the proposed new contract (Ex. 1) was approved by the Fund's shareholders.

On July 25, 1974, this Court granted defendants' motion to dismiss, as moot, the original complaint seeking equitable relief. Leave to file an amended complaint was granted plaintiff upon posting a $1,000.00 bond, pursuant to Local Rule 2 of the Civil Rules of this Court. Bond was posted, and an amended complaint was filed on August 14, 1974. The amended complaint makes the same allegations and seeks judgment voiding the new advisory agreement, requiring defendants to account for and pay over to AIF any rebate which would have been due had the expense ratio limitation of 1% remained in effect for 1973.

Trial of this action commenced on February 18, 1975 before the Court without a jury.

Factual Background of the Dispute.

AIF was formed by George Chestnutt in 1957. Since its inception, Chestnutt Corporation or its predecessors (all controlled by Mr. Chestnutt) served as adviser to the Fund, providing research and guidance in the administration of the Fund's assets, office space, and related office expenses, executive salaries and promotional costs.[4]

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[4] The Investment Advisory Agreement lists the items of expense as follows (Ex. 2, p. 17):

"7. The Investment Adviser shall furnish to [the Fund] such office space as may be necessary for the suitable conduct of

Mr. Chestnutt was one of the first investment advisers to develop a theory of investment strategy based on keeping complex statistical records or charts showing historical price and volume fluctuations, and relative performance of individual stocks and stocks of selected industry groups. Since 1946, Mr. Chestnutt has edited and published a weekly technical stock market letter, "American Investors Service."

Mr. Chestnutt and many respected investors believe that market trends can be predicted by analysis of statistics and charts showing trends with respect to price fluctuations of individual stocks, stocks in industry groups, and the stock market in general. Chestnutt Corporation furnishes the Fund with "continuing analysis of the action of over 1,000 issues by means of daily charts supplemented by a weekly computer analysis of relative market performance," and correlations of "economic findings with technical studies in the fields of money, credit availability and banking statistics." (Ex. 1, p. 4).

The Fund was organized on the theory that, unlike other funds, it would provide an opportunity to participate in a portfolio administered in accordance with the general theories expounded by the Chartists, and Mr. Chestnutt's

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the [Fund's] business and all necessary light, heat, telephone service, office equipment and stationery and stenographic, clerical, mailing and messenger service in connection with such office; and pay the salaries of all of the Fund's executives, and pay all promotional, travel, and entertaining expenses relating to Fund sales."

According to AIF's prospectus (Ex. 1, p. 3):

"The Fund . . . pays brokerage, transfer agent fees, costs relating to reports to shareholders, auditing and legal fees, custodian fees, registration and filing fees, and taxes, and membership fees of the Investment Company Institute."

theories in particular. This method or practice required extensive administrative overhead. At one time, Chestnutt Corporation employed 110 people to administer this Fund and its other accounts. By the end of 1974, the staff had been cut to approximately 37. (Tr. p. 69).

The preparation of charts and computer analyses makes the service provided by Chestnutt Corporation expensive, but the Fund's shares were sold and bought upon the representation that this unique investment strategy would be pursued by the Fund's manager. Although Chestnutt's methods may not have been particularly successful in recent years, they remain respectable, and enjoy acceptance among knowledgeable investors.

As an open-end no-load investment company, the Fund may have a board of directors "all the members of which, except one, are interested persons of the investment adviser" [15 U.S.C. § 80a-10(d)]. At the time of the events in suit, AIF's board consisted of eight members, three of whom were not "interested persons". The other five, including Mr. Chestnutt, were all affiliated in some fashion with Chestnutt Corporation.

Each contract between the Fund and the adviser was for a term of two years, but was submitted to the shareholders for approval annually as is required by the Act, and its terms were in compliance with the Act (15 U.S.C. § 80a-15). The annual fee received by Chestnutt Corporation was computed as a percentage of the net assets of the Fund.

The 1% expense ratio limitation was added to the contract renewed some years prior to the events in suit at the instance of state regulatory commissions, notably in California, where the Fund sold shares.

The investment performance of the Fund over the years had been relatively unsuccessful compared with other

funds.[5] Fund assets had declined in market value from $220,000,000.00 in September 1972 to less than $150,000,000.00 in May 1973. Expenses had been increasing due primarily to inflation. In 1970 the Fund instituted a minimum investment requirement of $400.00. Prior thereto, it had required no minimum investment. As a consequence, it had a large proportion of small accounts, and thus its administrative expenses of the sort which are directly related to the number of accounts (shareholders) were high, compared with funds which had few small shareholders.

Violation of Fiduciary Duty.

In 1972 and early 1973, AIF, like other funds, was suffering from a decline in the total market value of its assets, caused by shareholder redemptions and a general drop in market prices of securities. In May 1973, it appeared likely that unfavorable market conditions would continue, and the adviser's total fee would therefore decline with the asset value of the Fund. It also appeared likely that expenses of the Fund would increase with the foreseeable result that Chestnutt Corporation would then be required to refund some part of its fee to the Fund in compliance with the 1% expense ratio limitation contained in the advisory contract dated September 1, 1972 then in effect. Mr. Chestnutt thought this eventuality likely within a year or two (Deposition of George Chestnutt, June 4, 1974, p. 14).

The Board of Directors of AIF had frequently considered its rising expenses but had never considered increasing the expense ratio limitation until the matter was

[5] See Ex. 7, showing that for the five-year period January 1, 1967 to December 31, 1971, the Fund was last in "performance" of a group of 206 funds studied by "Fundscope," a respected financial publication

brought up by Mr. Chestnutt at a board meeting on May 21, 1973. Messrs. Cram and Lee, attorneys for the Fund and for Chestnutt Corporation were asked to make inquiries of those securities commissioners of the states requiring an expense ratio limitation, and to report to the board at its next meeting.

At the next meeting of the board on June 5, 1973, the proposed increase was approved to be implemented in a new contract to be submitted at the July meeting, and dated as of September 1, 1973. Eugene Ulrich, a disinterested director of the Fund distributed to the directors on June 5th a table (Ex. 14) listing twenty funds having assets over $100,000,000.00, their number of shareholders, turnover rate, percent of expenses, and management fees. This tabulation submitted by Ulrich was the only information the directors had before them when they were discussing the advisability of increasing the expense ratio. No further information was requested by the directors and none was offered by Chestnutt Corporation.

Mr. Ulrich's initiative in furnishing this information is insufficient to fulfill the requirements of 15 U.S.C. § 80a-15(c):

> ". . . It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company."

Plaintiff contends that a finding of failure to comply with this section, standing alone, establishes a *per se* violation of the Act, and therefore the advisory contract is voidable

at her instance on behalf of the Fund, pursuant to 15 U.S.C. § 80a-46(b):

> "Every contract made in violation of any provision of this subchapter . . . shall be void (1) as regards the rights of any person who, in violation of any such provision . . . shall have made or engaged in the performance of any such contract . . ."

The legislative history of the 1970 amendments to the Act does not support such a conclusion. One of the most important additions to the Act made in 1970 was the section under which plaintiff sues, 15 U.S.C. § 80a-35(b). The purpose of that section was to make it clear that fund managers have a fiduciary duty to the funds they advise; to give shareholders a right to sue for breach of that duty; and to overrule decided cases which had held that if advisory contracts were ratified by the shareholders, or in some states, approved by a vote of disinterested directors, shareholders must show mismanagement and waste of corporate assets before excessive management fees could be recovered. [See *e. g., Saxe v. Brady,* 40 Del.Ch. 474, 184 A.2d 602 (1962); *Meiselman v. Eberstadt,* 39 Del.Ch. 563, 170 A.2d 720 (1961)]. Such a rule was considered unduly restrictive in the mutual fund industry where the fund and its adviser are closely related and arm's length bargaining is normally absent.

> "Thus, upon a challenge in court to compensation or payments, the ultimate test, even if the compensation or payments are approved by the directors and stockholders, will not be whether it involves a 'waste' of corporate assets but will be whether the investment adviser has fulfilled his fiduciary duty to the mutual fund shareholders in determining the fee." 3 U.S.Code Cong. & Admin.News 1970, p. 4910, Senate Report No. 91-184.

Among the factors the Court "may wish to consider" in determining whether the adviser has fulfilled his fiduciary duty to the fund is "whether the deliberations of the directors were a matter of substance or a mere formality," and it was in an attempt "to assist the directors in discharging their duties" that Congress added to 15 U.S.C. § 80a-15(c) the requirement that the adviser furnish and the directors consider, relevant information regarding fees and payments to the adviser (3 U.S.Code Cong. & Admin. News 1970, p. 4910).

There is no indication whatever in the statute or the legislative history that a violation of § 80a-15(c) was intended to relieve the courts of responsibility to evaluate all the evidence before determining whether there has been a breach of fiduciary duty. Were it otherwise, there would be no need for the statement (3 U.S.Code Cong. & Admin. News 1970, p. 4910):

> "The section makes it explicit that the . . . plaintiff has the burden of proving to the satisfaction of the court that the defendant has committed a breach of fiduciary duty."

Such an interpretation of § 80a-15(c) would also make the following sections of § 80a-35(b) meaningless surplusage if all that must be shown is a failure to supply and consider information relevant to the fee, or other advantages to the adviser:

> "(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and

the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances."

Clearly, a court is not "authorize(d) . . . to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees" but is "authorize(d) . . . to determine whether the investment adviser has committed a breach of fiduciary duty in determining or receiving the fee." 3 U.S.Code Cong. & Admin.News, 1970, p. 4902. In doing so, the Court must exercise its traditional function of considering all the evidence in finding whether or not there has been a breach of fiduciary duty.

None of the Fund's directors, interested or otherwise, objected to the increased expense ratio on the ground that the Fund might be losing the advantage of a possible rebate during the unexpired term of the contract then in effect. Nor was it pointed out by Mr. Chestnutt that a rebate would probably be due for 1973. Apparently all that was considered was the disadvantage of the existing limitation to the adviser. The disinterested directors gave only the most cursory attention to the expense ratio increase, never considered opposing Mr. Chestnutt's suggestion or asking for

further information regarding Chestnutt Corporation's finances. Mr. Frank G. Fowler, who had no connection with Chestnutt Corporation, became a director of AIF in 1962. He testified (Deposition of March 29, 1974, pps. 19-20):

"Q. At the time the voting for the new advisory agreement took place, did you believe that you were giving up some advantage that the fund had? A. No.

Q. Did you believe you were obtaining some advantage for the fund before voting for the new agreement? A. I'm sure I must have felt that.

Q. What did you understand the advantage of the fund to be of having a one and a half percent expense limitation instead of a one percent expense limitation? A. Well, the advisor cannot operate at a loss, and judiciously, it appeared that he needed more compensation to actively perform his duties as an advisor to the fund.

Q. Was it your understanding that prior to June '73 that the advisor was operating at a loss?

* * *

A. I believe he was approaching it.

Q. Did Mr. Chestnutt present any financial or income statements of Chestnutt Corporation, or did he just make a representation? A. I believe that he did, but that I can't recall for sure.

* * *

Q. At any time during your time as a director of the fund, was there ever a discussion about obtaining a new advisor for the fund? A. I don't recall any."

Mr. Ulrich testified that the particular type of investment advice supplied by Chestnutt Corporation was "very

unique" and unavailable from any other adviser. Therefore he never considered changing advisers because "if I were to . . . change the type of advice . . . I would be going counter to the desires of the stockholders when they made the initial decision to buy the stock." (Tr. p. 87). See discussion, *supra*, p. 1323, concerning the special nature of Chestnutt's advice. This opinion was shared by the other disinterested directors. The importance the non-affiliated directors placed on retaining Chestnutt Corporation as investment adviser apparently made them susceptible to Mr. Chestnutt's suggestion at the May 21, 1973 board meeting that if the expense ratio were not increased (Deposition of George Chestnutt, July 11, 1973, p. 32):

> "inevitably, with the inflation rate out of control, expenses were going up and if contrarily the market kept going down it would be inevitable that somewhere down the road, if things didn't change, that it would reach the unfair proportions of perhaps bankrupting the adviser, or causing the adviser to have to completely get out of the business; that there was a very strong possibility that was down the line something like that could happen, and that I felt that the expense limitation was unfair. . . ."

However, none of the directors made any attempt to determine whether Chestnutt Corporation was in financial difficulty, or intended, absent the modification, to withdraw as adviser. The consolidated balance sheet of Chestnutt Corporation as of December 31, 1972 had been mailed to AIF directors on April 27, 1973. That company's total current assets on December 31, 1972 were $759,564.00. (Ex. 2, p. 11).

Mr. Chestnutt did not submit any more recent financial data to the Fund's board. A draft of the proxy materials was received by the directors before the next meeting on June 5, 1973. This also contained the 1972 balance sheet of Chestnutt Corporation.

Chestnutt Corporation had substantial assets, and Mr. Chestnutt himself did not consider his company to be in any imminent danger of bankruptcy: "it was only the possibility of future trouble that was worrying me. . . . It was the fact that this is the sort of thing that if you don't plan ahead, you are dead and I didn't want to be dead." (Deposition of George Chestnutt, June 4, 1974, p. 17).

In fact, Chestnutt Corporation's income had been decreasing but was still substantial. Fees from AIF for the first quarter of 1972 were $303,680.47; for the first quarter of 1973 they were $284,457.94. Mr. Chestnutt's salary from Chestnutt Corporation at its highest point in 1968 or 1969 was approximately $130,000.00 per year, but dropped to approximately $79,000.00 in 1972 and 1973. (Tr. p. 61).

While the financial stability of its adviser is a matter of legitimate concern to the Fund, there is no evidence any of the directors questioned Mr. Chestnutt's statements or attempted to verify their significance. Their only concern appears to have been that expenses were rising and thereupon they made the decision, in effect, that the Fund, rather than the adviser should bear the burden of the increase.

The directors of the Fund held a position of trust and confidence with respect to the Fund's shareholders, and owed them the obligations commonly associated with fiduciaries. § 80a-35(b) explicitly imposed upon Chestnutt Corporation the standard traditionally applied to persons in a fiduciary position, and directors of AIF knew or should have known that this is the standard by which their official acts would be measured.

The increase effective September 1, 1973 from 1% to 1½% in the expense ratio limitation was obviously beneficial to Chestnutt Corporation. Nothing in the record indicates any benefit flowing to the Fund from such increase. Mr. Chestnutt's claim that unless the increases were approved, Chestnutt Corporation's continued existence and capacity to function as adviser to the Fund would be threatened, is unsupported.

The issue of contract modification presented a clear conflict of interest between the Fund and Chestnutt Corporation. Such transactions will be upheld only if, after subjecting them to rigid judicial scrutiny, they are found to be fair. *Pepper* v. *Litton*, 308 U.S. 295, 60 S.Ct. 238, 84 L.Ed. 281 (1939); *United Hotels* v. *Mealey*, 147 F.2d 816 (2d Cir. 1945); *Securities Comm.* v. *Chenery Corp.*, 318 U.S. 80, 85, 63 S.Ct. 454, 87 L.Ed. 626 (1942).

Seeing its profits dwindling as the Fund's assets declined, it is not surprising that Chestnutt Corporation should want to eliminate the future possibility of a rebate to the Fund, but equity imposes a higher standard. *Meinhard* v. *Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928); *Rosenfeld* v. *Black*, 445 F.2d 1337, 1343-44 (2d Cir. 1971).

In *Rosenfeld, supra*, the Court held the investment adviser to a mutual fund breached its fiduciary duty by realizing a profit in connection with the appointment of a new adviser, and that the applicable standard of fiduciary duty was a matter of federal law incorporating wherever appropriate equitable safeguards long known to the common law, as has been held in *Brown* v. *Bullock*, 294 F.2d 415 (2d Cir. 1961). The Court noted that (*Rosenfeld, supra*, at 1345):

> "When Congress, in § 15(a), required shareholder approval of any new advisory contract, it must have meant an approval uninfluenced by any improper motivations on the part of the outgoing adviser-fiduciary."

The same may be said in this case. The desire to improve Chestnutt Corporation's profits was, perhaps, not "improper motivation" of the interested directors here, but to do so without full disclosure and discussion of Chestnutt's financial condition and the likelihood of a refund to AIF coming due under the balance of the agreed term of the then existing contract, was inappropriate. Without this, it cannot be said that, under all the circumstances, the contract was the result of arm's length negotiations. *Pepper* v. *Litton, supra*.

AIF's board was presented with the suggestion that its adviser faced insolvency, which is patently untrue on the record before this Court, and the right of the Fund to have the 1% limitation apply in the second year of the old agreement was surrendered. It is no answer to say there was a 60-day mutual cancellation clause and the contract was submitted to the shareholders each year. These are requirements of the Act [15 U.S.C. § 80a-15(a)(2) and (3)] and were intended to protect the parties from such eventualities as irreconcilable good faith disputes, good faith dissatisfaction with performance, dissolution of the Fund, or withdrawal by the adviser from business. It was not intended to be used as a means by which to repudiate a valid unexpired agreement solely in the self-interest of the adviser, since:

> "'in every contract there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract, which means that in every contract there exists an implied covenant of good faith and fair dealing,' *Kirke La Shelle Co.* v.

> *Paul Armstrong Co.*, 263 N.Y. 79, 87, 188 N.E. 163, 167 (1933)." *VTR, Inc.* v. *Goodyear Tire & Rubber Co.*, 303 F.Supp. 773, 777 (S.D.N.Y. 1969).

See also 3 Corbin, Contracts, § 568, pp. 331-334 (1960).

New York law permits parties to modify a contract without consideration, if the modification is in writing (Gen. Obl.Law. § 5-1103, McKinney's Consol.Laws, c. 24-A), but the parties here, because of the fiduciary relationship, could not do so except on reasonable grounds believed in good faith to be mutually beneficial. Under these circumstances it borders on fraud to suggest that the adviser was faced with insolvency during the period for which it had agreed to the 1% limitation. A different situation may exist with respect to the subsequent year.

The new contract ratified by AIF shareholders on July 18, 1973 must be considered a modification of the earlier contract as to the year September 1, 1973 to August 31, 1974 inclusive.

In accordance with 15 U.S.C. § 80a-46, I find that the modification is void and unenforceable against the Fund. Plaintiff is entitled for this reason alone, to recover damages on behalf of AIF in the amount by which expenses exceeded the 1% expense ratio limitation set forth in the original contract during its original term.[6]

Proxy Rule Violation.

We now turn to the proxy materials mailed on June 21, 1973. The statements in the proxy materials claimed to be

[6] Effective September 1, 1974, still another contract was entered into between the Fund and its adviser. This contract was ratified at a shareholders' meeting held in July, 1974. The validity and effect of this contract and the proxy statement used in connection with the shareholders' meeting at which it was ratified are not in issue in this case.

false or misleading are: (1) that the increase in the expense ratio limitation was proposed "as a result of cost increases over which neither the Fund nor the Adviser can exercise control," and (2) that "No higher fees or costs would have been incurred by the Fund had the proposed new Agreement been in effect in 1972." (Ex. 2, p. 6).

We observe preliminarily that the second statement quoted above and claimed to be misleading was added to the draft of the proxy solicitation materials at the instance of a member of the staff of the SEC in Washington, D.C., assigned to examine the proxy statement. (Ex. 11). Under the circumstances of this case, it is no defense to show that those filing the proxy statement were motivated by loose talk on the part of a government employee. Responsibility for the adequacy of proxy materials is imposed upon those soliciting the shareholders' votes, and not upon government employees who perform what is basically a police function. Defendants had the duty to stand up to the staff member if his suggestions were without merit. Indeed, they did so vigorously and successfully with regard to at least one other suggestion.[7]

[7] The same staff member apparently attempted to induce the Fund to inform its shareholders that it paid higher fees to its Adviser than most other funds. This attempt was rejected by defendants' counsel. See Ex. 11 and Tr. p. 9, *et seq.* A memorandum dated June 15, 1973 (Ex. 11) written by Douglas Cram, an attorney employed by Chestnutt Corporation, states that "They [the SEC staff] were basing this statement solely on the rate on the first $50 million [of assets]—and not on any actual calculation of the effective [overall] rate on current levels of [total] assets."

Mr. Cram stated that he knew of no study of the effective rates charged other funds, and requested that the SEC suggest such a study to him. The SEC apparently made no such suggestion, and the matter was dropped.

Plaintiff also complains of a failure to accede to a request made by the SEC staff to insert a statement in the proxy materials to the effect that the Fund's fees were higher than those paid by similar funds, and a failure to advise the Fund's non-affiliated directors of the SEC's request and of the fact that the fees were high. As to these complaints the Court finds no merit in plaintiff's contentions.[8]

I find that the statements quoted above are false and misleading. The proposed increase in the expense ratio was not the "result of cost increases over which the Fund nor the Adviser can exercise control," but was primarily the result of the decreasing net asset value of the Fund. The statement that "No higher fees or costs would have been incurred by the Fund had the proposed new Agreement been in effect in 1972" (Ex. 2, p. 6) represents a misleading half-truth and omission in that it fails to disclose that if the old agreement had remained in effect for its unexpired term, a refund would have been due the Fund in 1973.

The paragraph in its entirety is as follows (emphasis added):

The fees paid Chestnutt Corporation are computed on a decreasing scale, as follows:

.8 of 1% on the first \$50 million
.6 of 1% on the next \$50 million
.4 of 1% on the next \$200 million
.35 of 1% on the next \$200 million
.3 of 1% on net assets in excess of \$500 million.

The effective overall rate obviously depends on the current net asset value of the Fund. Exhibit 14 shows that the advisory fees paid by 14 of the 21 funds listed with rates beginning at .5 of 1% and then decreasing could under no circumstances exceed the fees paid by AIF. With its assets at approximately \$150,000,000.00 in mid-1973, the effective rate AIF paid Chestnutt Corporation was .6%. In 1972, however, with net assets at \$220,000,000.00, the rate would have been lower.

[8] See footnote 10 hereof.

"*As a result of cost increases over which neither the Fund nor the Adviser can exercise control,* the Fund and the Adviser have determined that the 1% annual expense ratio limitation in the current Investment Advisory Agreement shall be increased to 1½%. No increase in the fees paid or payable to the Adviser is proposed. The aggregate of annual operating costs, including the fee of the Adviser, will be limited to 1½% of average monthly net assets in the contract. Heretofore, the Advisory Contract required the Adviser to reimburse the Fund to the extent that total annual expenses (exclusive of interest and taxes) exceeded 1½ of average monthly net assets. Under the new agreement, no reimbursement from the Adviser would be required unless and until total annual expenses of the Fund (again, excluding interest and taxes) exceeded 1½% of average monthly net assets. The Investment Advisory fee schedule would not be changed under the new agreement; however, the higher allowable expense ratio limitation would benefit the Adviser by reducing the risk that some or all of the advisory fee would have to be reimbursed to the Fund due to an increase in rates for other expenses or changes in the average account size of American Investors Fund shareholders. *No higher fees or costs would have been incurred by the Fund had the proposed new Agreement been in effect in 1972.*"

With regard to the first statement italicized above, the shareholders should have been told it was the combination of decreasing net asset value and increasing expenses which resulted in a "risk" that the adviser would have to reimburse the Fund. The paragraph as a whole, particularly

with the addition of the last sentence, is misleading. That a refund might be due in 1973 if the old contract remained in effect for the balance of its agreed term of two years was material "in the sense that a reasonable investor might have considered (it) important," *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128, 153-54, 92 S.Ct. 1456, 1472, 31 L.Ed.2d 741 (1972); *Mills* v. *Electric Auto-Lite,* 396 U.S. 375, 90 S.Ct. 616, 24 L.Ed.2d 593 (1970); *Schlick* v. *Penn-Dixie Cement Corporation,* 507 F.2d 374 (2d Cir. 1974), in deciding whether to vote in favor of ratification of the proposed new advisory contract.

The quoted paragraph gives no indication whatever that a refund was ever even a remote possibility under any likely set of foreseeable circumstances, including rejection of the proposed new agreement. In this regard, it was misleading, and false. There is no doubt that Mr. Chestnutt and the other interested directors thought a rebate was likely, or they would not have sought an increase in the expense ratio. The importance they attached to this likelihood is "a major factor in determining whether (it) was a material fact." *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 851 (2d Cir. 1968).

The Court finds defendants breached the provisions of § 14(a) of the Securities Exchange Act [15 U.S.C. § 78n(a)] and Rule 14a-9 promulgated thereunder, by omitting to disclose in the June 21, 1973 proxy solicitation that the change in the advisory contract might result in loss of a foreseeable rebate to the Fund in the period September 1, 1973 through August 31, 1974. By the terms of § 20(a) of the Investment Company Act [15 U.S.C. § 80a-20(a)], a violation of § 14(a) of the Securities Exchange Act is also a violation of § 20(a) [*Monheit* v. *Carter,* 376 F. Supp. 334, 340 (S.D.N.Y. 1974)]. Therefore, pursuant to 15 U.S.C.

§ 80a-46, this violation of § 20(a) of the Act also renders the new contract void and unenforceable against the Fund, insofar as concerns the increase in the expense ratio limitation.

Demand Requirement of Rule 23.1, F.R.Civ.P.

Defendants suggest plaintiff may not prevail because of failure to make a timely demand on the directors. See Rule 23.1 F.R.Civ.P.; New York Bus.Corp.Law § 626(c), McKinney's Consol.Laws, c. 4. Important public policies require that the management of a corporation be entrusted in the first instance to the discretion of its directors. To protect these policies, and prevent the initiation and maintenance of strike suits brought solely to humiliate defendants and extract legal fees, such demands followed by refusal are ordinarily a condition precedent to derivative litigation. Here, clearly, demand would have been fruitless and accordingly is excused as unnecessary. Defendants resisted, tenaciously and effectively, plaintiff's attempt to enjoin the shareholders' meeting. This, and their defense of this litigation, taken together with the fact that their own proxy statement and their own acts were brought directly in question by plaintiff's claims, warrants a finding that any preliminary demand on the Fund or its directors would have been futile. *Papilsky* v. *Berndt,* 59 F.R.D. 95 (S.D.N.Y. 1973).

Expiration Date of Old Contract.

Defendants contend, based on their interpretation of paragraph 9 thereof, that the original advisory contract would have expired on June 30, 1974, rather than August 31st. That portion provides (Ex. 4, p. 14):

"The Corporation (Fund) agrees to pay to the Investment Adviser and the Investment Adviser agrees to accept as full compensation for all services rendered by the Investment Adviser hereunder for each of the Corporation's fiscal quarters on the last day of each quarter, a fee in an amount determined by applying the following quarterly rates to the value of the Corporation's net assets at the end of each calender quarter: * * * provided, however, that the annual fee of the Investment Adviser shall not be more than an amount which, when added to the other charges of the Corporation (exclusive of interest and taxes) shall result in total charges per annum to the Corporation inclusive of the fee of the Investment Adviser (but exclusive of interest and taxes) of 1% of the value of the Corporation's average monthly net assets for any year. For the first quarter in which this Agreement shall be in effect, the foregoing computations shall be made as if this Agreement was in effect for the entire quarter. For the quarter and the year in which this Agreement terminates, there shall be an appropriate proration on the basis of the number of days that this Agreement is in effect during the quarter and the year respectively. . . ."

It is not clear how defendants derive a June 30, 1974 expiration date from this paragraph.[9] The contract is dated

[9] The Annual Report of American Investors Fund, Inc. for December 31, 1973 (Ex. 13) "Notes to the Financial Statements, Note 3", discusses the effect of the new agreement as follows:

"At the Annual Meeting of Shareholders held on July 17, 1973 the shareholders approved a new investment advisory agreement for a term of two years effective September 1, 1973 *retroactive to July 1, 1973.* The new agreement is similar in

"as of September 1, 1972" and paragraph 11 provides (Ex. 4, p. 15):

"This agreement shall remain in effect for a period of two years from the date hereof. . . ."

Thus, the expiration date of the contract is clearly August 31, 1974, and the 1% expense ratio limitation must be applied for the periods during which the contract would have been in effect.

Defendants complain that such an interpretation would have the effect of providing for an expense limitation of 1% for part of calendar 1974 and a 1½% limitation for the latter part of calendar 1974, a result not contemplated by the parties. Whether the parties contemplated such a result or not, the agreement is so drafted by competent attorneys, it is not ambiguous, and must be construed as it is written.

The Fund kept its books and rendered its financial statements quarterly, on a calendar year basis. According to paragraph 9, computations are to be made *as if* the agreement had been in effect on July 1, 1972, but that does not imply the fee would be paid from July 1st, nor does it imply

all respects to the prior agreement with the exception of the limitation ratio of expenses as related to average monthly net assets which was increased to 1½% from 1% as provided in the prior agreement. Accordingly, *the adviser is required to refund each year any amount by which total expenses of the Fund*, exclusive of taxes and interest, *exceed 1½% of average monthly net assets for the period July 1, 1973 to December 31, 1973 and 1% of average monthly net assets for the period January 1, 1973 to June 30, 1973.*" [Emphasis supplied.]

There is no justification in either of the contracts for such an interpretation. Specifically, nowhere in paragaph 9 or elsewhere is there a provision that the contract shall be retroactive to July 1, 1973.

the agreement was in effect on July 1st. Paragraph 9 explicitly provides that when the agreement terminates, the fee and expense limitaion shall be prorated "on the basis of the number of days that this agreement is in effect during the quarter and the year respectively." Any such need to prorate would be obviated if the agreement terminated on June 30th, which is the end of a quarter. We will not assume the parties included gratuitous language in so vital a section of the agreement as the advisory fee paragraph.[10]

Reading the paragraph as a whole, it can only mean the first payment to the adviser under the contract was not to be computed on the basis of the average net asset value of the Fund for the month of September only, but on the basis of a figure representing an average of the net asset values for each of the three months in the quarter, July 1st through September 30th.

Damages; AIF Counsel Fees.

Equity requires that counsel fees paid or accrued by AIF as expenses for outside attorneys solely for the purpose of this litigation should not be considered as expenses in applying the 1% limitation. As to 1973, it is apparently not disputed that Philadelphia counsel were paid a special retainer of $7,500.00 in connection with the proceedings before Judge Broderick. The Court is requested to allocate $2,000.00 of Mr. Cram's time and $15,000.00 of the billings of general counsel directly to this case.

[10] Conceivably if the contract had been terminated prior to expiration, by giving sixty days notice, or by impossibility of performance, supervening illegality, force majeure, etc., the pro-ration clause would be useful. But its plain meaning is not limited to such premature termination.

As to Mr. Douglas Cram, who is described as the Fund's "resident counsel" (Def. Post-Trial Memo, p. 17), the Court declines to allocate any portion of his salary as requested. It is doubtful that the Fund's expenses would be diminished in any amount had Mr. Cram been otherwise engaged.

We are asked (*ibid*, p. 17) to "view $15,000.00 of the $43,735.00 paid to (the Fund's general counsel) for legal services in 1973 to the important function of protecting the rights of 100,000 shareholders to exercise their franchise and have their annual meeting." This we would not be inclined to do unless it could be shown that a specific amount was separately billed and paid in 1973 solely by reason of this action. Since, as will appear below, it is necessary to take additional evidence by stipulation or otherwise, we leave it open to defendants to show how much of the 1973-74 legal expenses are directly attributable to this action and would have been avoided but for the litigation. Plaintiff may not, in good conscience, be the one who pulls the trigger bringing the override provisions into effect.

Plaintiff, by bringing this action in Philadelphia on the eve of the 1973 shareholders meeting, forced the Fund to incur attorneys' fees to assure that the shareholders' meeting would go forward, and avoid the threatened expense of cancelling and rescheduling the meeting. Plaintiff sought an injunction to which she was held not entitled, pursuing that remedy in an inappropriate venue. Plaintiff is partly responsible for AIF's expenditure of counsel fees and the size thereof, at least before the case was transferred to this District. In addition, research discloses no cases in point decided under 15 U.S.C. §§ 80a-35(b), as amended in 1970, and therefore novel issues were raised by this suit. The Court finds this case was defended, here and in Philadelphia, in good faith.

The parties agree no refund would have been due AIF in 1972. Therefore, 1972 is excluded from the damage computation.

Since the expense limitation is to be computed for every calendar year or portion of a calendar year covered by the agreement, damages must be computed first for all of 1973, then separately for January 1, 1974 through August 31, 1974.

Through no fault of counsel to any party, the Court is unable to fix the damages for that portion of 1974 abovementioned. Because the parties assumed validity of their own differing interpretations given the old contract, the record does not contain sufficient information upon which the Court may make an award including those months. This is so notwithstanding agreement made with the Court at the trial (Tr. p. 183).

Conclusion.

Counsel are requested to submit a stipulation in writing setting forth the applicable amounts in accordance with this opinion, or if such a stipulation cannot be mutually agreed upon, so to advise the Court within twenty (20) days from the date hereof so consideration may be given as to how such data may be elicited.

The foregoing constitutes findings of fact and conclusions of law pursuant to Rule 52, F.R.Civ.P.

SUPPLEMENTAL FINDINGS AND CONCLUSIONS

Prior findings and conclusions filed herein July 23, 1975, are modified and amplified as hereinafter set forth.

The correct figure for 1973 average net assets in $166,-058,784.00. The 1% limitation based upon this amount would be $1,660,587.00.

The Court approves the practice followed in taking the sum of 13 figures and dividing by 13 to obtain the average monthly assets for the year 1973. This is the method which the Fund has used for many years prior to the commencement of this litigation, and may be regarded as having been within the contemplation of the parties when the contract sued upon was signed. It is not totally unreasonable. The alternate method suggested by plaintiff would in effect give consideration only to end of month dates for eleven months, and would produce a distorted and unreasonable result.

Plaintiff has consented to deduct from expenses for 1973 the sum of $12,500.00 as attorneys' fees directly attributable to this litigation. This includes $7,500.00 paid to Philadelphia counsel, and $5,000.00 allocable to general counsel to the Fund. The Court regards these sums as reasonable. The fee of Philadelphia counsel was fixed and paid at arms length. While general counsel invested additional time in the matter, much of it concerned conferences with Philadelphia counsel, and duplicative work performed jointly with Philadelphia counsel. Furthermore, the same attorneys were, at least indirectly, representing the interests of Chestnutt and his corporation at the same time. Under all the circumstances present here, an allowance of $5,000.00 is reasonable and adequate.

Accordingly, the damages for 1973 are to be computed as follows:

Expenses net of interest and taxes per Ex. 15, p. 3	$1,691,417.00
Less: Legal Fees	12,500.00
	$1,678,917.00
Subtract, 1% limitation,	1,660,587.00
Rebate for 1973 (Damages)	$ 18,330.00

With respect to the damages for that portion of 1974, the agreement clearly contemplated a pro rating of expenses through its termination. See p. 26, *et seq.* and fn. 10 of Findings and Conclusions dated July 23, 1975.

Generally accepted accounting principles consistently applied must be followed. This requires accruals where appropriate. For purposes of the advisory agreement, expenses are expenses, and there is no provision therein excluding unusual or non-recurring expenses. The Fund spent substantial amounts in 1974 to liquidate the holdings of small shareholders in order to save future expenses. To the extent the Fund treated those costs as expenses during the applicable period, they remain just that. The Court sees no basis to require the exclusion of those items from the damage computation, and will treat the accrual in the third quarter as a *pro rata* expense.

As to 1974 legal fees, we are advised that no bill has been rendered to the advisor, represented, properly, by the same counsel in the subsequent trial. Recognizing the stakeholder status which the Fund acquired as soon as the injunctive aspect of this litigation was resolved, the Court finds, solely for the purposes of this computation, that the sum of $3,000.00 is a reasonable amount to pay for its representation in this litigation during the first eight months of 1974, and will treat that sum as being exempted from the expenses subject to the limitation.

The rebate for the first eight months of 1974 is calculated as follows:

Expenses for 1st six months on accrual basis, net of interest and taxes	$ 800,204.00
Redemption program accrued (⅔ x 39,068.73)	26,045.82

Advisory fee accrued for July and August (Schedule attached to 8/15/75 letter from Chestnutt's counsel to plaintiff's counsel to plaintiff's counsel)	104,851.00
Total	$ 931,100.82
Total [carried forward]	$ 931,100.82
Less allowance for legal expenses	— 3,000.00
	$ 928,100.82
Expense Limitation (¶13 of Defendant's post trial exhibit at 8 months basis, or 8/12ths of 1%)	— 869,758.80
Rebate for 1974 (Damages)	$ 58,342.02

The Court declines as a matter of discretion to award pre-judgment interest.

Settle a final judgment on five (5) days notice in favor of American investors Fund, Inc. and against Chestnutt Corporation, in the amount of $76,672.00. The judgment may contain appropriate provisions retaining jurisdiction to award legal fees and disbursements to plaintiff out of the recovery following appellate finality, and upon notice.

APPENDIX E

Opinion of U.S.C.A., 2nd Circuit, Nov. 4, 1976

MILDRED GALFAND, on behalf of herself and on behalf of American Investors Fund, Inc.,

Plaintiff-Appellee and Cross-Appellant,

v.

CHESTNUTT CORPORATION,

Defendant-Appellant,

and

American Investors Fund, Inc.,

Nominal Defendant.

Nos. 202, 315, Dockets 76-7156, 76-7170.

United States Court of Appeals,
Second Circuit.

Argued Oct. 6, 1976.

Decided Nov. 4, 1976.

Clendon H. Lee, New York City, for defendant-appellant.

Ronald Litowitz, New York City (Kreindler & Kreindler and Edward A. Grossmann, New York City, Lyman & Ash, Philadelphia, Pa., of counsel), for plaintiff-appellee and cross-appellant.

Before KAUFMAN, *Chief Judge,* and MANSFIELD and MESKILL, *Circuit Judges.*

IRVING R. KAUFMAN, *Chief Judge:*

The relationship between investment advisers and mutual funds is fraught with potential conflicts of interest. The typical fund ordinarily is only a shell, organized and controlled by a separately owned investment company adviser, which selects its portfolio and administers its daily business. Compensation for these services is determined under an advisory contract, the terms of which are all too often dictated to unwary or negligent fund directors and fund shareholders by the investment adviser.

The vulnerability of mutual fund shareholders to unscrupulous advisers prompted Congress to enact Section 20 of the Investment Company Amendments Act of 1970, 15 U.S.C. § 80a-35(b),[1] imposing a fiduciary duty on the in-

[1] The statute provides in relevant part:

(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for sevices, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for beach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

vestment adviser with respect to its receipt of compensation for services rendered to the fund. We are called upon to consider whether, in securing a mid-term modification of its advisory contract with American Investors Fund, Inc. (AIF), Chestnutt Corporation observed its duty of uncompromising fidelity to the interests of AIF security owners.

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(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 80a-9 and 80a-48 of this title, section 78*o* of this title, or section 80b-3 of this title, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

15 U.S.C. § 80a-35(b).

In addition, we are required to decide whether the proxy statement sent to AIF shareholders contained material misstatements or omissions in violation of 15 U.S.C. § 80a-20(a) and the Security and Exchange Commission's Rule 14a-9. We hold that Chestnutt Corporation abused its position of trust by acquiring from the mutual fund, without full disclosure to the AIF Board of Directors, a patently one-sided revision of the advisory contract and that it subsequently violated Rule 14a-9 in obtaining shareholder ratification of the new contract on the basis of a misleading proxy statement. Accordingly, we affirm the judgment of the district court. We also remand, for the reasons hereinafter set forth, for a recalculation of damages.

I.

A brief recitation of the facts will facilitate understanding the legal issues presented for review. AIF was founded in 1957 by George A. Chestnutt, Jr., who became and remains both a Director and President of the Fund. Like other mutual funds, AIF provided small investors an opportunity to pool their venture capital to obtain the benefits of professional financial advice and diversification at a relatively modest cost. The Fund was unusual, however, in that it offered its security holders an investment strategy inspired by the principles of what was characterized as Chartism.[2]

This policy was devised by Mr. Chestnutt, who managed the Fund's investments through his control of the invest-

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[2] Portfolio transactions were executed on the basis of complex formulae derived from statistical records and charts depicting the historical price and volume fluctuations of selected stocks, correlated with technical studies of money supply, credit availability and banking trends.

ment adviser, appellant Chestnutt Corporation.[3] The adviser, in addition to supervising the Fund's portfolio, furnished office space and clerical personnel, and paid both the salaries of the Fund's executives and all promotional expenses relating to Fund sales.[4] In return, Chestnutt Corporation received quarterly reimbursement of its expenses and a fee calculated as follows:

Quarterly Rate	*Equivalent Annual Rate*	*Net Assets of the Fund*
0.2%	0.8%	on the first $50 million
0.15%	0.6%	on the next $50 million
0.1%	0.4%	on the next $200 million
0.0875%	0.35%	on the next $200 million
0.075%	0.3%	on the net assets in excess of $500 million.

The fee was subject, however, to an "expense ratio limitation".[5] Total charges to the Fund, including the fee, but

[3] Mr. Chestnutt was President, Director and 47% owner of the investment adviser.

[4] Paragraph 7 of the Advisory Contract provides:

> 7. The Investment Adviser shall furnish to the Corporation such office space as may be necessary for the suitable conduct of the Corporation's business and all necessary light, heat, telephone service, office equipment and stationery and stenographic, clerical, mailing and messenger service in connection with such office; and pay the salaries of all of the Fund's executives, and pay all promotional, travel, and entertaining expenses relating to Fund sales.

[5] The expense ratio limitation is included in Paragraph 9 of the Advisory Contract:

> provided, however, that the annual fee of the Investment Adviser shall not be more than an amount which, when added to the other charges of the Corporation (exclusive of interest and taxes) shall result in total charges per annum to the Corporation inclusive of the fee of the Investment Adviser (but exclusive of interest and taxes) of 1% of the value of the Corporation's average monthly net assets for any year.

excluding interest and taxes, could not exceed 1% of the value of the Fund's average monthly net assets for any year. Chestnutt Corporation's successful effort to increase this expense ratio limitation to 1½% spawned the current litigation.

Prior to 1973, Chestnutt Corporation's fee was not seriously threatened by the expense ratio limitation. But by May of that year a general deterioration of securities prices had resulted in a sharp decline in the value of the Fund's assets.[6] Inflation simultaneously was causing a rapid increase in the adviser's expense. In an effort to limit rising costs, Chestnutt Corporation initiated a program of redemptions designed to eliminate shareholder accounts too small to justify service costs. The economies thus achieved, however, caused still greater reduction in the Fund's net asset value. This ominous conjunction of factors led Mr. Chestnutt to believe that, under the 1% expense ratio limitation provided by the two-year advisory contract in force since September 1, 1972, Chestnutt Corporation would be required to begin paying rebates to the Fund within two years.

To forestall this eventuality, Mr. Chestnutt decided to increase the expense ratio limitation to 1½%. Acquiescence of the AIF Board of Directors was not difficult to obtain. Chestnutt first proposed revision of the advisory contract at the May 21, 1973, Board meeting. The measure was approved without any difficulty at the next meeting, on June 5. The directors of the Fund gave the proposal cursory scrutiny at best. Mr. Chestnutt at no time gave any indication that by this action, the Fund was foregoing a possible rebate in 1973; nor did he present any evidence

[6] The market value of AIF's assets had declined from $220 million in September, 1972 to less than $150 million in May, 1973.

to support his gloomy assertions that current trends threatened the financial viability of the investment adviser.[7] It is clear from the record that Mr. Chestnutt's personal domination was such that the directors never considered for a moment opposing his suggestion.

Having secured the Board's consent, Mr. Chestnutt sought shareholder ratification of the proposed increase in the expense ratio limitation. The next Annual Meeting was scheduled for July 17, 1973. On June 21 proxy materials were mailed to the Fund's security holders. The materials justified the contract revision as one resulting from "cost increases over which neither the Fund nor the Adviser can exercise control," ignoring entirely the decline in the Fund's net asset value, an equally prominent factor in the "squeeze" on Chestnutt Corporation's profits. The proxy statement added, moreover, that "no higher costs would have been incurred by the Fund had the proposed new agreement been in effect in 1972," although Chestnutt knew the amended contract was likely to increase the ultimate compensation due the investment adviser in 1973.

Despite the effort of appellee Mildred Galfand, suing derivatively on behalf of the Fund, to secure a preliminary injunction,[8] the Annual Meeting was held as scheduled on July 17 and the new advisory contract was ratified by a wide margin. The modification in the expense ratio took effect on September 1, 1973. Galfand, meanwhile, continued

[7] The district court found Chestnutt Corporation's income had been decreasing but was still "substantial." Fees from AIF for the first quarter of 1973 exceeded $284,000, down only fractionally from the corresponding period in 1972. And Mr. Chestnutt's salary approached $80,000 in 1972 and 1973, a significant sum even when compared to his $130,000 income several years earlier.

[8] *Galfand* v. *Chestnutt*, 363 F.Supp. 291 (E.D.Pa. 1973).

to pursue her remedy at law. A change in venue from the Eastern District of Pennsylvania to the Southern District of New York was subsequently granted, *Galfand* v. *Chestnutt*, 363 F.Supp. 296 (E.D.Pa. 1973), and on July 23, 1975, Judge Brieant, after a trial without a jury, found that Chestnutt Corporation breached its fiduciary duty to AIF in securing the expense ratio increase and made false and misleading statements in the proxy materials to obtain shareholder approval of the revamped agreement, in violation of 15 U.S.C. § 80a-20(a) and Rule 14a-9, 17 C.F.R. § 240.14a-9 (1976).[9]

II.

Congress, in imposing a fiduciary obligation on investment advisers, plainly intended that their conduct be governed by the traditional rule of undivided loyalty implicit in the fiduciary bond.[10] It is axiomatic, therefore, that a self-dealing fiduciary owes a duty of full disclosure to the beneficiary of his trust. Former Chief Judge Friendly stated the principle succinctly:

> under the scheme of the Investment Company Act an investment adviser is "under a duty of full disclosure of information to . . . unaffiliated directors in every area where there was even a possible conflict of interest between their interests and the interests of the fund" —a situation which occurs much more frequently in the

[9] *Galfand* v. *Chestnutt*, 402 F.Supp. 1318 (S.D.N.Y.1975).

[10] See *Rosenfeld* v. *Black*, 445 F.2d 1337, 1343-45 (2d Cir. 1971), *cert. dismissed*, 409 U.S. 802, 93 S.Ct. 24, 34 L.Ed.2d 62 (1972) (federal standard of directorial fiduciary responsibility incorporates, where appropriate, standards of the common law), and cases cited therein.

> relations between a mutual fund and its investment adviser than in ordinary business corporations . . .

Fogel v. *Chestnutt*, 533 F.2d 731, 745 (2d Cir. 1975), *cert. denied*, —— U.S. ——, 97 S.Ct. 77, 50 L.Ed.2d 86 (1976), (citing *Moses* v. *Burgin*, 445 F.2d 369, 376 (1st Cir.), *cert. denied*, 404 U.S. 994, 92 S.Ct. 532, 30 L.Ed.2d 547 (1971)).[11] Moreover, even where a fiduciary has made full disclosure, it is the duty of a federal court to subject the transaction to rigorous scrutiny for fairness. *See Pepper* v. *Litton*, 308 U.S. 295, 306-07, 60 S.Ct. 238, 84 L.Ed. 281 (1939).[12] We believe it is clear that, in applying these standards, Chestnutt's conduct in obtaining approval of the contract modification must be found to have fallen far short of the elevated norm Congress expected.

A thorough search of the record reveals no evidence that Chestnutt, in discussing the issue with the AIF directors, made any reference to the fact or even suggested that the Fund would lose a rebate if the expense ratio were raised to 1½% of average monthly net assets. And, although the financial soundness of the investment adviser is of proper concern to a mutual fund, Chestnutt failed to support his

[11] In *Fogel*, mutual fund shareholders alleged that the adviser had violated its fiduciary duty by failing to apprise independent fund directors, 15 U.S.C. § 80a-2, of the possibility of using volume discounts on portfolio brokerage transactions to reduce advisory fees. *See also* portions of the legislative history describing the obligation of the adviser to supply fund directors with information reasonably necessary to perform their evaluative function, 1970 U.S. Code Cong. & Adm. News, p. 4910.

[12] Congress implicitly approved evaluation of advisory fee structures under traditional equitable standards by disavowing cases which upset management contracts only upon a showing of "corporate waste." *See, e.g., Saxe* v. *Brady*, 40 Del.Ch. 474, 184 A.2d 602 (1962); 1970 U.S.Code Cong. & Adm.News, pp. 4901-03.

Cassandran prophesies of possible bankruptcy with financial statements or corroborating figures. Had he supplied the AIF Board of Directors with data more recent than the 1972 annual report, it would have been apparent that Chestnutt Corporation had ample assets[13] and substantial income despite recent unfavorable trends. Chestnutt appears to have ignored completely his duty to promote responsible directorial judgment by supplying information sufficient to enable the Fund's Board to evaluate the new contract "with an eye eager to discern . . . rather than shut against" the interests of AIF. *Fogel* v. *Chestnutt*, *supra* at 749. His influence with the Fund's directors can hardly be questioned. The result of this dereliction was a patently one-sided revision of the advisory contract which placed the entire burden of rising costs and a falling market on the Fund, whose financial condition was not accorded even a passing concern.

III.

Chestnutt asserts that to upset the advisory contract approved by the shareholders is tantamount to judicial meddling with corporate democracy. The irony of such an argument will become apparent after examination of the proxy materials, particularly when scrutinized in the light of the rules promulgated by the Securities and Exchange Commission to assure fair corporate suffrage by accurate explanation to the shareholder of issues upon which his vote is sought. *See Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 381, 90 S.Ct. 616, 24 L.Ed.2d 593 (1970).

We set out in full the relevant paragraph of the proxy statement purporting to advise AIF security holders of the

[13] Chestnutt Corporation's total current assets on December 31, 1972 were $759,564.

rationale for the proposed increase in the expense ratio limitation:

> *As a result of cost increases over which neither the Fund nor the Adviser can exercise control, the Fund and the Adviser have determined that the 1% annual expense ratio limitation in the current Investment Advisory Agreement shall be increased to 1½%.* No increase in the fees paid or payable to the Adviser is proposed. The aggregate annual operating costs, including the fee of the Adviser, will be limited to 1½% of average monthly net assets in the contract. Heretofore, the Advisory contract required the Adviser to reimburse the Fund to the extent that total annual expenses (exclusive of interest and taxes) exceeded 1% of average monthly net assets. Under the new Agreement, no reimbursement from the Adviser would be required unless and until total annual expenses of the Fund (again, excluding interest and taxes) exceeded 1½% of average monthly net assets. The Investment Advisory fee schedule would not be changed under the new agreement; however, the higher allowable expense ratio limitation would benefit the Adviser by reducing the risk that some or all of the advisory fee would have to be reimbursed to the Fund due to an increase in rates for other expenses or changes in the average account size of American Investors Fund shareholders. *No higher fees or costs would have been incurred by the Fund had the new Agreement been in effect in 1972.*

Judge Brieant found the italicized portions of this proxy statement false and misleading under Rule 14a-9.[14] The dis-

[14] Rule 14a-9, 17 C.F.R. § 240.14a-9(a) was promulgated by the Securities and Exchange Commission pursuant to § 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a), and provides:

trict judge determined that the shareholders should have been informed that the new expense ratio was sought to avoid penalizing the adviser not only for cost increases beyond its control but also for depreciation of the Fund's net assets. In addition, according to Judge Brieant, the security holders should have been told that a refund might be due in 1973 if the 1% expense ratio term had remained in force for the duration of the old contract.[15]

But the appellants argue vigorously that these findings are infirm because Judge Brieant, lacking the guidance of the Supreme Court's opinion in *TSC Industries* v. *Northway,* 426 U.S. 438, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976),

> § 240.14a-9 False or misleading statements.
>
> (a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

The Rule is pertinent here by virtue of Section 20(a) of the Investment Company Act, 15 U.S.C. § 80a-20(a), and the Commission's Rule 20a-1, 17 C.F.R. § 270.20(a)-1, making the proxy rules applicable to securities issued by registered investment companies.

[15] Appellant argues that he cannot be held liable for the inaccuracy of the last sentence quoted above because the SEC required him to include it in the proxy statement. But it is axiomatic that the issuer of a proxy statement is responsible for the truthfulness of its assertions, *see, e.g.,* Rule 14a-9(b). Moreover, Chestnutt easily could have clarified the sentence to avoid misleading Fund shareholders. Finally, appellant conveniently ignores that the adviser vehemently rejected an SEC request to include in the proxy materials a statement that AIF paid a higher advisory fee than most other mutual funds.

evaluated the materiality of the omitted facts under an erroneous standard. It is true, of course, that the test applied below—omissions are material if "a reasonable investor might have considered them" so—was repudiated in *TSC Industries.* The correct formulation was enunciated by the Supreme Court thus:

> [An] omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote . . . Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available. *Id.* at 449, 96 S.Ct. at 2133, 48 L.Ed.2d at 766.

We are of the view that even under the *TSC Industries* test, the proxy statement here was materially misleading.

In so holding, we have the benefit of Judge Brieant's careful appraisal of the key paragraph in the proxy statement. This paragraph deceptively stated Chestnutt's avowed reason for fearing the possibility of a future rebate by omitting to mention the primary component of the rebate formula—declining Fund assets—a subject of considerable interest to shareholders who were being asked effectively to increase the fee of their investment adviser. And the adversion to the absence of a rebate in 1972 if the 1½% limitation had been in effect, without any indication whatever that a refund was even a remote possibility, under any set of circumstances, in 1973 and 1974, was a misleading half-truth. Chestnutt does not seriously dispute the finding that he and the fund directors believed a rebate possible. Indeed, this belief was precisely the reason they

desired the expense ratio increase. By presenting some negative factors, the inclusion of these omitted facts certainly would have significantly altered the "total mix" of information made available to voting shareholders. Accordingly, since we find that shareholder approval for the revised advisory contract was secured by means of a materially misleading proxy statement, we affirm the district court's order rescinding the new agreement, 15 U.S.C. § 80a-46(b).

IV.

There remains the issue of damages for us to deal with. There is no dispute regarding Judge Brieant's finding that in 1973 Chestnutt Corporation was unjustly enriched under the voided contract by $18,330. The controversy revolves around the appropriate figure for 1974, when the challenged advisory contract was superseded on September 1 by a new one whose validity is not here in question. In light of the maze of figures presented by both sides at this appellate stage, we believe that a proper determination of damages must be based upon a clearer, more certain record. Accordingly, we remand for a recalculation of 1974 damages by the district judge. We are able, however, to provide some guidance on the method of computation. The court should include all expenses for July and August, 1974, in calculating the rebate. Moreover, we believe that the advisory fee for those two months should be included in the damage formula. Although the payment due is apparently measured by the value of the Fund's assets at the end of the quarter (i.e. October 1), the fee represented services rendered daily during July and August. We note that the parties contemplated such proration of expenses in their advisory contract:

¶9. For the quarter and the year in which this agreement terminates, there shall be an appropriate proration in the basis of the number of days that this Agreement is in effect during the quarter and the year respectively . . .

This merely treats the advisory fee as an accrued expense of the Fund.

The judgment is affirmed as modified by a recomputation of the damages on remand.

APPENDIX F

Decision on Remand

[52] * * *

The Court: To anybody who would spend a morning trying an $800 issue wouldn't be trivial, Mr. Litowitz. And I don't mean that critically.

Mr. Litowitz: I understand, your Honor.

The Court: I think it's come to an end here and the court is now going to make its findings in compliance with the remand and mandate of the Court of Appeals.

I incorporate in my present findings the various statements of position that I have taken on the record during the course of this hearing, and of course everything [53] in my prior decisions to the extent not modified by the Court of Appeals and anything therein contained. Let me begin by stating that I am clear that the new agreement was effective September 1, 1974. This fact was found by me and it was affirmed by the Court of Appeals. It is also clear that the court must include all expenses for the period from January 1, 1974, through August 31, 1974, in calculating the rebate for that year; and the Court of Appeals has also advised that the adviser's fee for those two months of July and August, 1974, should be included even though the payment due was apparently measured by the value of the fund's assets at the end of the quarter, and the Court of Appeals impliedly, and I agree with this and I would so find even had they not stated it, believes that the parties contemplated a proration of expenses under paragraph 9 of the contract; and the court believes that it was the objective intention of the parties as evidenced from the four corners of their contract that the services rendered by the defendant to the fund could end at any time.

The fund could terminate on 30 days' notice, or the contract could have expired according to its terms on August 31, 1974, in either of which events the adviser and the fund would be expected to strike a balance of what was owing without regard to future events. It would be ridiculous [54] to assume that the parties contemplated that if another adviser had taken over the administration of the fund on August 31st, and through bad fortune or bad management had depreciated the assets following August 21st, that the percentage limitation under the contract would be adjusted adversely to this particular defendant by reason of events with which he had no factual relationship or connection whatever. I think the contract clearly calls for apportionment, and it has to be done on a reasonable basis, that is what the parties contemplated, and they contemplated that their rights would be capable of ascertainment for the quarter and year in which the agreement terminates based on appropriate proration on the basis of the number of days that the agreement was in effect during the quarter and year specifically, and that is what I proposed to do and the damages fixed here are intended to be based on that interpretation.

The court finds that the expenses for the period January 1, 1974, through August 31, 1974, exclusive of interest, taxes and the legal fees in the amount of $3,000 which were excluded in my prior opinion, are as follows:

For the first six months $800,205, and for July and August, 1974, $191,368; making a total of $991,573. The court accepts the plaintiff's figure which is also set forth [55] on the basis of the computation at page 4 of the brief filed by Rogers & Wells as properly based on an average net asset figure relating only to the first eight months of 1974. For mathematical reasons which were explained at

the trial and which were used by the court last time this matter was attended to, it's necessary to use nine figures in order to get a consistent effective average net asset figure, and that is stated as $1,304,812, and the court adopts that figure as the basis for the apportionment. I note that if the 12-month period was used, as was apparently done by the court in the 1973 computation, the figure would be $1,223,472. However, I think that anything that happened after the termination of the agreement was fortuitous and not attributable to anything done under the agreement. The court has to assume the possibility that others could have been managing the fund after this agreement ended.

The agreement was deemed to be drawn with that in mind, and therefore I don't think it's appropriate or necessary to use the 12-month figure which would be slightly lower.

The court does not believe that the increase in fees for the four-month period of 1974 can have any basis on the damages here. If that were possible, all of the [56] rights of the fund under the old contract could be cancelled out merely by making a prospective adjustment in the right to a high enough figure for the last four months to make a 12-month averaging come out even, and that's unreasonable, and I decline to accept that argument, and reject it.

Based on the computations which are contained in the brief filed by Rogers & Wells at page 4 and which I understand the plaintiff agrees, the limitation for the 8-month period based on eight-twelfths of 1 percent, which is a proration as contemplated by the agreement, would amount to $869,875. The net result of that is that there is a recapture or damages for the year 1974 properly due the fund in this case mounting to $121,698.

There will be added to that the figure of $18,330 for 1973, a figure which the Court of Appeals observed was not in dispute.

The next question with which the court will deal is the matter of pre-judgment interest. I think it was absolutely clear at all times from and after December 17, 1975, that this fund was entitled to $18,330. I think there was a bona fide dispute and an uncertainty as to the liquidated nature of the damages as to the rest of the prior judgment which the court had entered. I think the parties [57] were contesting that figure in good faith on their appeal, and I think regretfully the trial record did not contain adequate information. The court believes that there was such a close interrelationship between the fund and its investment adviser because of the overlapping directors and officers, that it was reasonable and proper for the adviser at least to have paid the $18,330 on December 17, 1975; and for its failure to do so the court will impose pre-judgment interest on that amount at 6 percent per annum from that date.

Also, I find that as of November 4, 1976, the figures which the court has found here were readily available to the parties couldn't have been computed by any Certified Public Accountant employed by the defendant or the fund who had undertaken to do so; and again, because of the ficudiary obligation which this defendant has to the fund, and the overlapping officers and directors, I think that the court would regard the sum awarded today as something which should have been paid on and after November 4, 1976, when the Court of Appeals spoke, so that the entire judgment will carry interest from November 4, 1976, to the date of entry; and there will be costs awarded on this hearing, and of course there are costs which were taxed in the Court of Appeals and in the prior trial.

[58] It seems reasonable to me that there should be a final corrected judgment entered here which would by its terms either vacate or replace all prior judgments outstanding. The court did not sign the proposed order which was settled on notice before me on January 28, 1977, because I had anticipated that I would act on the remand almost immediately thereafter; so I would therefore require that a judgment in proper form which the attorneys I am sure can agree upon be presented which will cover all of the matters in one paper so that there will be no question about it and vacate any prior judgments unless someone finds a reason for not doing it in that fashion.

The court assumes that plaintiff's counsel will make an application in due course for compensation for services here, and the judgment may reserve jurisdiction for purposes of such an application if that is what they want to do. That matter may be withheld until appellate finality which seems reasonable because the court assumes that the results achieved would bear on the award. If you don't want to do that you may set a timetable in the judgment within which proper submission will be made assuming there is going to be such an application.

The foregoing constitutes my directions and findings of fact and conclusions of law on remand in this [59] case. I would like to have a judgment either agreed to as to form among the three attorneys or if you are unable to do that settled on two or three days' notice so that it might be entered promptly.

Now, if there is any matter which the court has not touched on to permit you or help you make a complete record here with me, I will entertain any requests at this time for other or further or additional findings to be made.

• • •

APPENDIX G

Judgment of U.S.C.A., 2nd Circuit, Oct. 25, 1977

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the 25th day of October, one thousand nine hundred and seventy-seven.

Present:

HONORABLE J. EDWARD LUMBARD
HONORABLE WILFRED FEINBERG
HONORABLE ELLSWORTH A. VANGRAAFEILAND
Circuit Judges.

77-7280

MILDRED GALFAND, on behalf of herself and on behalf of AMERICAN INVESTORS FUND, INC.,

Plaintiff-Appellee,

—against—

CHESTNUTT CORPORATION,

Defendant-Appellant,

and

AMERICAN INVESTORS FUND, INC.,

Nominal Defendant.

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is affirmed.

Appellant is attempting to reargue the merits of the prior appeal in this case, which decided that appellant was liable for its breach of fiduciary duty. Galfand v. Chestnutt Corp., 545 F.2d 807 (2d Cir. 1976). The cases cited by appellant that were decided after the prior appeal are all distinguishable. Judge Brieant's recalculation of damages on remand is affirmed as entirely consistent with our prior opinion. The appeal is frivolous, and double costs are awarded appellee pursuant to FRAP 38.

/s/ J. EDWARD LUMBARD
J. EDWARD LUMBARD

/s/ WILFRED FEINBERG
WILFRED FEINBERG

/s/ ELLSWORTH A. VANGRAAFEILAND
ELLSWORTH A. VANGRAAFEILAND
Circuit Judges